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ECONOMIC
OUTLOOK

Chamber of Commerce of the United States

October/November 1986

CAUTIOUS OPTIMISM

by
Richard W. Rahn and Rajni Bonnie Ohri

The U.S. economy remains basically strong despite the fact that some recently released numbers were not very encouraging. Any uncertainty regarding the near term outlook has to do with how individuals and businesses will respond to the tax reform legislation recently enacted. While some analysts worry that the lackluster (0.6 percent) increase in real GNP during the second quarter may foreshadow further weakness in economic activity, a closer examination of the data shows that this is far from the case. The second quarter revisions reinforced the sources of strength: consumer spending grew at a 6.5 percent rate, investment in producers' durable equipment rose by 19.9 percent, and residential investment increased by 13.5 percent. However, the second quarter data also showed a continuing deterioration in the nation's trade deficit. Exports of goods and services decreased by $9.4 billion while imports increased by $18.5 billion, pushing real net exports to a $154 billion deficit.

The near term forecast remains positive. Historically low financing rates produced record high car sales in early September; domestic auto volume soared 36.9 percent from a year earlier, averaging 18.5 million cars sold at an annual rate, in early September. However, the drop off in domestic car sales in the aftermath of the late summer sales incentives was just as pronounced: by mid-September car sales had dropped to a seasonally adjusted annual rate of 11.5 million units. The drop off was larger than many had expected so soon after the introduction of the financing incentives, but it was not surprising in light of the diminishing supply of eligible models. As a result, third quarter sales of cars should average 10.3 million units, significantly above average for the past year. The strength in car sales is translated into a sharp increase (approximately $15 billion) in consumer durable spending during the third quarter. Personal consumption expenditures rose by 1.1 percent in August, led by a 14.8 percent surge in spending on motor vehicles and parts as consumers rushed to take advantage of the record low finance rates offered at the month's end. Auto sales are also being buoyed by forward buying incentives resulting from the tax reform legislation. Because capital cost recovery allowances are less generous under the new tax law, individuals have an added incentive to buy now. This was the largest increase in consumer spending since December 1985. However, since the rise in car sales is almost entirely accounted for by a drop in inventories, it will not be reflected in the third quarter GNP figures.

The surge in domestic car sales has also been reflected in retail sales. Retail sales increased by 0.8 percent in August following a 0.3 percent increase in July. The strength in consumer spending has reflected strong growth in personal income which rose by 0.4 percent in August. The rise in personal income included a 0.7 percent increase in wage and salary disbursements in the manufacturing sector, which had declined in the previous two months. Real personal disposable income rose by 6.4 percent in the first quarter and 7.3 percent in the second quarter. Personal income, particularly the wages and salaries component, should strengthen further to reflect improvements in employment. After declining for three consecutive months, the civilian unemployment rate inched up to 7 percent in September from 6.8 percent in August. The uptick returned the unemployment rate to its June level. The summer drop and subsequent rise in joblessness reflects both faulty seasonal adjustments and increases in the labor force.

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TABLE I
UNITED STATES ECONOMIC OUTLOOK 1986-1988
Prepared by the U.S. Chamber of Commerce
(Percent change from previous period at seasonally adjusted annual rates.)

	QUARTERS										YEARS			
	Actual			Forecast							Actual	Forecast		
	85:4	86:1	86:2	86:3	86:4	87:1	87:2	87:3	87:4	88:1	1985	1986	1987	1988
GROSS NATIONAL PRODUCT														
Real GNP	2.1	3.8	0.6	2.4	3.7	2.6	2.9	3.8	4.0	4.3	2.7	2.6	3.0	4.3
Consumption	1.7	3.6	6.2	6.6	1.3	2.7	2.1	2.1	2.3	3.3	3.5	4.1	2.9	3.0
Residential Investment	3.4	11.0	14.5	-1.1	-1.4	-1.8	-0.5	4.1	4.7	4.2	3.9	7.6	0.7	5.1
Nonresidential Investment	12.5	-15.1	-0.9	0.0	0.2	1.5	1.1	3.0	2.5	5.0	9.3	-0.9	1.1	4.6
Equipment	18.7	-17.0	19.6	3.8	1.7	1.3	0.0	2.1	1.6	4.7	10.1	4.2	2.6	4.3
Structures	0.3	-10.8	-35.2	-8.7	-3.5	1.8	3.9	5.3	4.8	5.7	7.7	-11.3	-2.5	5.4
Exports	8.2	7.1	-9.8	-1.5	7.5	10.2	10.8	13.3	13.5	13.7	-2.0	0.2	7.5	13.2
Real Net Exports (82$B)	-132.0	-125.9	-153.9	-162.5	-159.4	-149.9	-138.6	-125.9	-114.7	-104.7	-108.2	-150.4	-132.3	-93.6
Imports	23.3	0.2	15.8	5.8	2.7	-0.4	-1.2	-0.4	1.1	2.6	3.8	9.1	1.8	2.4
Government Purchases	22.7	-27.5	11.0	5.9	23.4	-18.5	-0.3	6.1	16.2	-14.5	10.9	3.1	1.8	0.8
Final Sales	2.7	-1.3	3.4	3.9	3.2	1.2	2.9	4.1	4.9	2.9	4.2	2.4	3.0	4.1
Change in Business Inventories (82$B)	-5.2	39.9	15.1	1.9	6.4	19.4	19.4	17.0	9.4	23.1	9.0	15.8	16.3	23.3
Industrial Production	2.0	2.0	-0.9	2.1	4.8	3.1	4.2	6.1	6.7	6.1	2.6	1.8	3.8	6.5
Total New Car Sales (mill.)	10.3	11.0	11.0	13.3	10.7	10.7	10.9	10.8	10.9	11.0	11.2	11.5	10.8	10.8
Domestic Car Sales (mill.)	7.0	7.8	8.1	10.3	7.8	7.7	7.9	7.8	7.8	7.8	8.2	8.5	7.8	7.6
New Housing Starts (mill.)	1.77	2.00	1.91	1.82	1.81	1.75	1.78	1.81	1.82	1.85	1.74	1.88	1.79	1.94
EMPLOYMENT, WAGES AND PRICES														
Civilian Unemployment Rate (%)	7.0	7.1	7.2	6.9	6.9	6.9	6.8	6.8	6.6	6.4	7.2	7.0	6.8	6.2
Compensation	3.7	3.0	2.3	2.6	2.5	3.6	2.6	2.7	2.9	3.3	4.0	3.0	2.8	3.1
Productivity	-3.4	4.3	-0.4	0.3	1.3	0.6	0.9	1.4	1.4	1.4	0.5	0.8	0.8	1.4
Unit Labor Costs	7.3	-1.3	2.7	2.3	1.2	2.9	1.7	1.3	1.4	1.8	3.7	1.2	1.9	1.9
Consumer Price Index	4.3	1.4	-1.7	1.5	2.4	2.5	2.6	2.8	2.9	2.8	3.5	1.7	2.2	3.0
Implicit GNP Deflator	3.6	2.5	1.8	1.8	1.3	1.7	2.0	2.3	2.5	2.6	3.3	2.5	1.8	2.6
Prime Interest Rate (%)	9.5	9.4	8.6	7.8	7.1	6.8	6.3	6.2	6.2	6.2	9.9	8.2	6.4	6.2
3-mos. Treasury Bill Rate (%)	7.2	7.0	6.1	5.4	5.3	5.2	5.2	5.0	4.9	4.9	7.5	6.0	5.1	4.7
Corporate Bond Rate (%)	10.6	9.6	9.0	8.8	8.6	8.1	7.7	7.3	7.2	7.1	11.4	9.0	7.6	6.8
Real Personal Disposable Income	2.8	6.4	7.2	0.6	1.6	4.6	1.5	1.9	2.0	9.3	1.4	3.4	2.6	3.9
Profits from Current Production ($B)[1]	189.2	207.3	199.9	190.5	197.3	158.7	160.0	185.0	190.5	187.8	189.0	198.7	173.5	195.7
GOVERNMENT FISCAL POLICY ($B)[2]														
Unified Receipts											736	769	830	925
Unified Outlays											937	993	1020	1083
Unified Deficit											-201	-224	-190	-158

[1]After-tax corporate profits with inventory valuation and capital consumption allowances.

[2]Unified budget figures on a fiscal year basis.

Source: U.S. Chamber of Commerce, Forecasting Section, using the Washington University model of the U.S. economy.

FORECAST ASSUMPTIONS

This month's outlook contains the August revisions to the National Income for the second quarter of 1986. The forecast incorporates provisions of the recently enacted tax reform plan. The nation's money supply M(1) is assumed to grow by 13.7 percent during 1986, 8.4 percent in 1987, and 5.9 percent during 1988. The trade weighted exchange value of the dollar falls by 17.3 percent in 1986, 3.0 percent in 1987, and 3.0 percent in 1988. The price of imported oil averages $14.00 per barrel in 1986 and $15.00 per barrel in 1987 and 1988. The federal minimum wage is not expected to increase.

Housing starts rose 0.4 percent in August to a 1.82 million seasonally adjusted annual rate. Starts should average 1.8 million units for 1986 as a whole, up from 1.7 million units in 1985. In spite of the slowdown in second quarter GNP growth, the housing market has been able to maintain a very healthy level of starts, consistent with demographic and replacement demand. Spurred by low interest rates and increased incomes, residential investment continues to rise. We expect that the current pace of housing activity will continue during the next two years.

While several factors, including moderate wage increases, low levels of capacity utilization and the drop in oil prices will help hold the line on consumer price increases, the decline in the value of the dollar is likely to offset somewhat these downward pressures. Higher import prices should contribute to a steady, albeit slow, acceleration in prices during 1987. The impact of higher priced imports is reflected in the difference between the rise in the consumer price index (CPI), which includes imported products, and the implicit GNP deflator which does not. The overall price level, as measured by the GNP deflator, is anticipated to rise by only 1.8 percent this year, and 2.6 percent in 1987, while the CPI is expected to rise by 2.2 percent and 3 percent, respectively.

The continued decline in the foreign exchange value of the U.S. dollar is slowly being translated into a rebound in U.S. export growth. Indeed, the monthly merchandise trade deficit improved in August, declining to $13.3 billion from its July peak of $18 billion. The decline in the deficit was largely due to an increase in agricultural exports (the first since April), and a substantial decrease in imports of manufactured goods. A steady decline in the rate of growth of imports should become evident as U.S. economic activity settles into a more moderate rate of growth and the demand for imports subsides. Similarly, the improved price competitiveness of U.S. exports and stronger growth abroad should spur the growth of exports.

The data presented not only shows that the U.S. economy is performing well but that prospects for the remainder of this year and next remain strong. In addition to tax reform, the outlook will be shaped by the impact of low oil prices, the decline in the value of the dollar and low interest rates. The stimulus from these factors will gather momentum toward the end of the year. Real GNP is expected to rise by 3 percent in 1987 and 4.3 percent in 1988.

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This month's issue of *Economic Outlook* is devoted to the Chamber's annual analysis of the prospects for U.S. industry. In keeping with recent concerns regarding the impact of foreign competition on U.S. industry, the industrial outlook details how some industries have met this challenge, and provides a forecast of industrial production and employment for 1987.

INDUSTRIAL OUTLOOK

by
Rajni Bonnie Ohri

Economic growth is an uneven process, invariably accompanied by a gradual shift in the composition of economic activity. Changes in the composition of output and employment also occur as some industries adapt more successfully than others to the changing economic environment. Thus, even during periods of general economic expansion some industries will grow slowly or stagnate, while others decline. Indeed, the expansion of the rapid-growth industries depends partially on the release of resources from contracting sectors.

The factors shaping the present character of American industry vary from industry to industry. For instance, the decline in world oil prices has benefited some industries (i.e., plastics and transportation equipment) and wreaked havoc upon others (i.e., oil field machinery). And the problems facing American agriculture have had repercussions throughout the agricultural equipment and chemicals sectors. However, two major changes in the economic environment have had a significant impact on the performance of and the outlook for every one of the nation's industries. These are technological advancements and innovations, and increased foreign competition. The winners of this new industrial revolution will be those industries and firms that adapt successfully to this competitive environment.

A new era of manufacturing is emerging. Thanks to technological advances, American firms can now turn out a greater diversity of products and product models to satisfy the needs of its customers. Nowhere is this fundamental change more evident than in the automobile and textile industries. Pinned against the wall by foreign competition, U.S. automakers have made an industry-wide commitment to high technology, building new factories and modernizing the old ones, thereby increasing efficiency, labor productivity and product quality. The trend is now spilling over to the suppliers of parts to auto firms. But the changes do not stop at the factory gate. This new competitive atmosphere has translated into im-

proved consumer services, including performance guarantees and financial services. Thus, today U.S. auto buyers do more than test drive different car models and compare standard equipment; they also compare service quality.

In the textile industry, which has suffered extensive damage through competition from imports, new generation machines clean cotton and other fibers ten times faster than was possible a decade ago. Looms produce a hundred yards of cloth an hour – twice as fast as ten years ago. In addition, textile firms are dropping unprofitable product lines and concentrating efforts in the manufacture of those products where they can compete more effectively.

In the footsteps of these industries, other major firms that are aggressively pursuing high technology include heavy equipment manufacturers and machine tool builders. Throughout the heavy equipment industry – at Caterpillar Tractor, Navistar, and others – advanced technology is coming on apace. Machine tool builders have stepped up their interest in innovation after watching their traditional dominance of the world market slide into a net trade deficit. Their newly aroused concern has coincided with the availability of low cost electronics, which has made possible the incorporation of sharply improved capabilities into their products.

Until recently, American industry had not recognized the full potential of foreign markets. Only now have specific industries and firms begun to embark on vigorous export programs and reap the potential benefits. Because of the large size of our domestic market, many companies, in the past, felt less urgency about opportunities abroad and failed to make the sustained investments needed to develop overseas markets. However, as we discussed in last month's issue of *Economic Outlook*, the decline in the value of the dollar opens up new markets for U.S. goods, both for domestic companies that were already exporters and for those who had not previously explored the possibility.

For the past few years, U.S. industry has been engaged in a massive drive to lower the costs of doing business. This has been achieved through a variety of options, such as outsourcing, closing inefficient plants, or opening plants abroad. Companies realize that in order to stay competitive, they must adapt to the new competitive environment and continue to innovate with new products and marketing strategies. Industries may revitalize domestic operations through infusions of Japanese management and production technology; they can also hammer down wage costs by farming out production jobs and buying services from outside vendors. Others find it more beneficial to ride the merger wave and shuffle existing assets than to raise capital to invest in new plant and equipment.

Industrial Production, Employment and Trade

Industrial production is anticipated to increase by 3.8 percent in 1987 following an estimated increase of only 1.8 percent in 1986. Production in the manufacturing sector is expected to post a 3.4 percent increase, with both the durable and nondurable sectors sharing in the improved performance. After years of flat growth, output of textile mill products is expected to rise by 7.7 percent. The leather and products industry, however, will continue to experience output declines, dragging down industry performance (see Table 1).

TABLE 1

INDUSTRIAL PRODUCTION BY INDUSTRY
1985-1987
(Annual Rates of Change)

	1985(a)	1986(e)	1987(f)
Total Production	2.3%	1.8%	3.8%
Manufacturing	2.6	1.5	3.4
Nondurables Manufacturing	2.4	3.6	3.7
Food & Products	3.1	3.2	4.2
Tobacco Products	-0.7	-2.3	-0.2
Textile Mill Products	-1.1	7.7	2.3
Apparel Products	-1.1	3.3	1.6
Paper & Products	0.2	4.4	3.7
Printing & Publishing	4.9	2.9	3.6
Chemicals & Products	4.4	3.9	4.0
Basic Chemicals	-0.5	-0.7	5.0
Petroleum Products	-0.8	5.4	3.3
Rubber Products	2.5	3.1	5.6
Tires	-3.0	-4.3	5.7
Leather & Products	-7.5	-8.8	0.3
Durables Manufacturing	2.8	0.0	3.2
Lumber & Wood Products	3.6	6.6	0.1
Furniture & Fixtures	3.7	3.6	-0.9
Stone, Clay & Glass Products	2.3	3.6	-1.0
Primary Metal Products	-1.9	-2.4	3.3
Basic Steel & Mill Products	-3.1	-0.6	2.4
Fabricated Metal Products	5.0	-0.7	0.1
Nonelectrical Machinery	3.2	-2.2	5.7
Metalworking Machinery	5.1	2.0	4.2
Office & Computing Machines	5.5	-2.3	7.0
Electrical Machinery	-1.8	-1.4	5.3
Transportation Equipment	8.5	2.0	2.1
Motor Vehicles	8.6	-3.6	-4.5
Instruments	2.2	2.3	5.2
Miscellaneous Manufactures	-1.3	1.4	1.7

(a) Actual (e) Estimate (f) Forecast

Source: U.S. Chamber of Commerce, Forecasting Section, using the Data Resources, Inc. macro model of the U.S. economy.

Reflecting the economic expansion, total nonfarm employment, which rose by an estimated 2.5 million jobs in 1986, should increase by an additional 2 million jobs in 1987. After falling by a projected 0.3 percent this year, manufacturing employment should resume modest growth in 1987, with the nondurable manufacturing sector being the strongest source of job growth (see Table 2). Outside of manufacturing, the strongest source of new

TABLE 2

EMPLOYMENT BY INDUSTRY
1985-1987
(Annual Rates of Change)

	1985(a)	1986(e)	1987(f)
Nonfarm, Total	3.3%	2.8%	2.0%
Manufacturing	-0.3	-0.3	0.6
Nondurables Manufacturing	-1.0	0.7	0.9
Food & Products	-0.3	1.8	0.6
Tobacco Products	0.8	-4.9	-4.2
Textile Mill Products	-5.7	0.8	2.2
Apparel Products	-5.1	0.1	0.4
Paper & Products	0.3	1.0	0.7
Printing & Publishing	4.3	3.1	0.9
Chemicals & Products	-0.3	-1.6	1.0
Petroleum Products	-6.1	-6.2	3.5
Rubber Products	1.2	1.6	0.7
Leather & Products	-12.5	-5.9	0.8
Durables Manufacturing	0.1	-0.9	0.5
Lumber & Wood Products	-0.4	3.6	3.0
Furniture & Fixtures	1.3	0.9	-1.4
Stone, Clay & Glass Products	-0.4	1.9	1.1
Primary Metal Products	-5.2	-4.3	-1.1
Fabricated Metal Products	0.3	-1.4	-0.5
Nonelectrical Machinery	-0.7	-3.6	1.0
Electrical Machinery	0.4	0.4	0.4
Transportation Equipment	0.4	0.4	0.4
Instruments	0.4	0.4	0.4
Miscellaneous Manufactures	-3.5	0.2	-0.1

(a) Actual (e) Estimate (f) Forecast

Source: U.S. Chamber of Commerce, Forecasting Section, using the Data Resources, Inc. macro model of the U.S. economy.

TABLE 3

EXPORTS AND IMPORTS BY INDUSTRY
(Percent Change)

	EXPORTS			IMPORTS		
Industry	1984	1985	1986(a)	1984	1985	1986(a)
Food & Products	0.4%	-9.1%	7.7%	16.4%	4.1%	-1.2%
Tobacco Products	-0.6	6.3	31.1	8.3	-11.4	2.0
Textile Mill Products	-1.2	-5.2	8.7	37.4	4.2	19.8
Apparel Products	-4.4	-4.3	15.5	39.7	12.2	15.2
Lumber and Wood Products	-5.3	-1.1	5.6	9.3	5.5	12.0
Paper & Products	5.3	-10.1	6.9	30.9	1.0	2.8
Printing & Publishing	4.2	-9.3	-1.8	34.6	12.2	28.5
Chemicals & Products	15.0	-3.7	-0.6	28.2	6.8	5.4
Petroleum Products	-8.9	6.2	-25.4	-1.7	-10.2	-23.9
Rubber Products	5.8	-5.8	2.2	44.5	8.2	13.3
Leather & Products	15.2	-9.1	-9.0	28.0	13.6	18.1
Leather Footwear	-11.4	-17.7	3.9	27.2	37.6	14.9
Construction Materials	-14.2	-12.6	-8.1	75.8	53.4	15.6
Metalworking Machinery	4.4	9.8	5.5	50.8	27.9	23.0
Electronic Components	19.1	-2.4	7.9	46.1	83.6	23.8
Industrial Electronic Equipment	-1.2	-9.9	-9.2	29.9	-11.6	10.4
Computers	28.0	3.7	-6.2	na	na	na
Motor Vehicles	16.1	21.8	9.5	27.2	24.4	27.3
Instruments	2.6	-0.4	2.7	36.8	-13.8	25.6
TOTAL	11.2	-0.5	1.6	20.7	6.5	-6.2

(a) Data for 1986 is only available through the month of July. To calculate the rate of growth for 1986 the value of exports and imports for the first 7 months of the year were compared to the same period in 1985.

na not available.

Source: U.S. Department of Commerce.

jobs in 1987 is anticipated to be the finance, insurance and real estate industry, where employment is forecasted to increase twice as fast as total nonfarm employment.

An examination of the 1986 pattern of exports and imports reflects a steady decline in the rate of growth of imports (see Table 3). However, the problem in the foreign trade sector remains the performance of real exports. Nevertheless, with the continued slide in the value of the dollar in foreign exchange markets, total exports next year are expected to increase while import growth subsides. Total exports should rise by an estimated 1.6 percent this year while imports should fall by over 6 percent.

Industries such as tobacco, electronic components, computers, and apparel will enjoy substantial improvements in export performance this year. Many other industries (crude petroleum, construction materials, food products and electronic components), are expected to experience a slowdown in the rate of growth of imports in 1986 compared to 1985.

The remainder of this article discusses how specific events and decisions have served an important role in determining each industry's performance and presents our outlook for industrial production and employment next year.

Industry Detail

Construction

The construction sector is expected to exhibit modest growth in 1987, albeit down from the robust pace of the last two years. Although construction activity remained strong throughout 1986, residential investment is expected to increase by only 0.7 percent next year while investment in nonresidential structures falls by 2.6 percent as growth in office and commercial construction slows. Construction of retail facilities, because it is linked closely to homebuilding, will continue to grow but at a slower pace than previous years, as new housing starts average 1.8 million units next year.

Educational and medical facilities, gas utilities and

telecommunications are expected to be the most rapidly growing segments of nonresidential construction projects next year. However, this sector is primed for significant adjustment since office space has been overbuilt in many regions of the country, where vacancy rates reach as high as 18 percent. Since office buildings constitute a significant proportion of nonresidential construction, the downturn will have a large impact on total construction. Public works construction will continue to increase throughout next year, with the biggest gains in road building, water supply and military construction.

Although employment in the construction industry should increase by an estimated 5.5 percent in 1986, it is anticipated to decline by 1.3 percent in 1987. Despite the recent moderation in wage increases, construction has remained one of the highest paying industries, as measured by average hourly earnings. Aided by belt-tightening measures taken this year, home builders' profits are anticipated to increase in 1987.

Declining interest rates and inflation, rising availability of credit and confidence in the economy are important determinants of the strength and mix of residential construction activity in 1987. More importantly, the effects of tax reform on the real estate sector will have a significant impact on both the primary and secondary mortgage markets. Under the new package, the rental cost of capital on residential building increases significantly. During the first year of enactment, this may depress commercial market demand and property values, resulting in a reduction in office buildings and apartments, and therefore, construction activity.

Lumber and Wood Products

The increase in residential construction activity in 1986 created a strong demand for wood and lumber products. Industrial output of lumber and wood products will rise by an estimated 6.6 percent this year, but production should rise by only 0.1 percent in 1987 as growth in residential investment increases at a slower pace, and the decline in nonresidential construction continues. Profits, however, are expected to decline next year because of lower prices for wood products, weakness in pulp markets and competition from Canadian imports.

Overall, second quarter 1986 industry earnings registered modest gains, but Canadian imports (which have captured 35 percent of the U.S. market) continue to displace domestic products, contributing to excess supply and depressed prices. Although there has been no significant increase in the industry's overall import penetration ratio, a growing proportion of domestic demand is being met by Canadian imports. As a consequence, a serious confrontation over Canada's growing raw timber exports to the U.S. has developed. Another factor contributing to oversupply was preventive harvesting last year to avoid pest damage.

In response to the growing pressure from imports, firms such as Georgia-Pacific Corporation, are streamlining operations, modernizing equipment and specializing in areas where imports have not yet made significant inroads. The firm is substantially increasing its production of low-cost substitutes for plywood – a sizable market in which the Canadians do not compete aggressively. Many companies also hope to enter the booming market for remodeling and repair, which now consumes about 20 percent of lumber production.

The industry is counting on gains from the continuing drop in the U.S. dollar, which should boost lumber and wood exports to Japan, China and Europe. Indeed, according to the American Paper Institute, exports of wood pulp have risen by 20 percent since the beginning of 1986 from the same period in 1985. However, pressures from Canadian competitors will probably not ease because the U.S. dollar has not weakened significantly *vis-à-vis* the Canadian dollar.

Stone, Clay and Glass

As with the lumber and wood products industry, the fortunes of the stone, clay and glass sector are also tied to residential construction activity. Consequently, as residential construction exhibits slower growth next year, industry output will decline by 0.1 percent. Employment, however, is anticipated to rise by 1.1 percent in 1987. Declining raw material prices and lower energy costs have boosted industry profits substantially.

Output of cement and structural clay products, used extensively in residential construction, is expected to fall by 6 percent next year, after rising by an estimated 11 percent this year. The cement industry is still feeling the impact of the dollar's strength as foreign competition continues to depress domestic prices. Similarly, clay imports from Mexico and Canada have become a problem for some U.S. producers serving border areas.

Following several years of declining profits and a shrinking market share, the glass container industry is implementing cost cutting measures and improving operating rates and productivity in order to boost output. Industrial production of glass and glass products is expected to rise by 2.5 percent in 1987, following a projected 5.8 percent increase this year.

Nonferrous Metals

After little growth in 1986, rising demand in the automotive and capital goods industries should contribute to a 3.3 percent increase in nonferrous metal production in 1987. After rising this year, industry profits should continue to increase in 1987 as the benefits of cost cutting programs offset lower prices at major companies.

The industry, which includes producers of nickel, lead,

zinc, copper and aluminum, is still beset with problems that made the last recession the worst in its history. The nonferrous metals industry continues to be battered by low prices, global excess capacity and foreign competition. It also faces special problems which are independent of general business conditions, such as substantial downsizing and substitution of new and lighter materials in construction and in the production of autos and heavy equipment. Lead producers, for instance, have suffered as a result of the elimination of the product from paint and gasoline. In addition, fiber optics are expected to make increasing inroads into the copper cable market, further retarding the demand for copper. Zinc is enjoying increasing usage in the automotive, appliance and construction industries, which account for over 70 percent of all zinc produced. Galvanizing will continue to be the largest application for zinc, although competition from other protective coatings will intensify.

Lower prices and severe competition from imports have led many nonferrous metals producers to diversify and significantly reduce costs. Producers are shifting their emphasis to precious metal and energy-related production. Companies have lowered production costs by combining substantial overhead and personnel reductions with new, more efficient production processes.

The positive impact of the dollar decline has already been felt by some aluminum producers. During 1986, aluminum imports fell by an estimated 4 percent while exports rose by 23 percent, and further increases in export shipments are expected next year. As a result, Alcoa and other aluminum producers have raised effective prices on some of their most widely used products. Producers are concentrating their efforts on developing more sophisticated aluminum products for use in everything from aircraft fuselages to computer chips. Alcan, for instance, is now in the process of developing aluminum-powered batteries and aluminum-coated hard-disk drives for computers. Increasingly, companies are producing primary aluminum facilities abroad where advantages, such as inexpensive power, proximity to raw materials and growing markets, exist.

Industry officials do not expect any significant increase in the demand for copper next year. A worldwide oversupply of the metal persists, continuing to depress prices. The major producing countries, Chile, Peru, Zaire, Zambia and the Philippines, all of which are heavily in debt, are unwilling to cut production because copper is their main source of foreign exchange earnings. Domestic copper producers have made considerable progress in cutting production costs, closing over 50 percent of their idle capacity and reducing the workforce. In spite of the Japanese demand for copper concentrates (for which there is a relatively high industrial demand) supply of copper still exceeds demand.

Iron and Steel

The current depressed conditions of the steel industry can largely be attributed to the long-term decline in the steel intensity of the U.S. economy and the highly competitive trade environment. Although the Administration's import restraint program is intended to alleviate the steel trade problem, imports continue to pour in, capturing 23.8 percent of the domestic market in 1986. Worldwide steel capacity continues to exceed demand. This imbalance has led to intense competition among nations for market shares, which in turn has contributed to sharp declines in the prices of steel products. As a result, profitability has suffered, and in steel producing nations, unemployment, plant closings and painful restructuring are common.

Steel consumption in the U.S. depends primarily on the demand for durable goods such as construction machinery, appliances and autos. Steel has become a less important component of the productive process, in part because of product substitution (in some cases, plastics are substituting for steel) and more importantly, because of the steady shift away from goods produced by heavy industry towards electronics, services and information processing. Finally, even in industries where steel remains a key input, such as autos, improvements in design have reduced the amount of the metal needed. In 1973, for example, 14.5 million cars and trucks were sold, and the U.S. industry used 23 million tons of steel. Last year, 15.7 million vehicles were sold, and only 13 million tons of steel were used. As a result, U.S. producers are forecasted to ship only 70 million tons of steel in 1987, down 5 percent from this year's level.

Individual companies will continue to compete for additional market share next year, especially in plate, large structural and tubular product lines, where slack capacity is the greatest. Improved efficiency and productivity are being realized through mergers, consolidations, and joint ventures. Increasingly, these arrangements are international in scope. For example, LTV and Sumitomo Metals Industries of Japan have formed a joint venture which is scheduled to begin producing electrogalvanized steel by next year. Last year, Inland Steel began discussions with Mitsui for equity participation in a steel mill.

There is also the ongoing process of further cost-cutting, including employment reductions and the installation of more efficient high-tech equipment to improve productivity and quality. Computerized production has reached 99 percent at one of USX Corporation's plants and automation is increasing at other sites. To compete with substitutes such as plastics and aluminum, which are making inroads into traditional steel markets, many steelmakers are diversifying into new markets as illustrated by the merger of USX Corporation and Texas Oil & Gas Corporation.

In the past fifteen years, minimills have captured 20 percent of the steel market, largely in wire rods and bars. A rush of new entrants into this sector, however, has resulted in excess capacity. The minimills are continuing to move into more profitable lines such as the flat hot-rolled steel market which is used for barrels, bridges and casings for industrial machines and equipment.

Industry production should rise by 2.4 percent in 1987. However, because industry wages are 50 percent higher than the national average, employment is expected to remain flat as producers attempt to contain costs and boost productivity.

Nonelectrical Machinery

The nonelectrical machinery industry has not escaped the problems of weak demand and foreign competition that continue to plague a large number of the nation's industries. Although the import penetration ratio for the industry as a whole stands at 17 percent, this overall average conceals major differences between categories within the sector. There is virtually no foreign competition in the domestic market for some industries such as oil field machinery (whose import penetration ratio is only 1 percent) and internal combustion engines (2 percent). However, other industry sectors, including farm machinery, machine tools, and textile machinery, face import penetration ratios of 20 percent, 53 percent, and 40 percent, respectively.

In an effort to meet the challenge from foreign suppliers, the industry has increased purchases of capital equipment to modernize existing facilities. Other efforts to improve international competitiveness include offshore purchases, joint ventures, licensing arrangements and increased spending on research and development. For example, Warner & Swasey has an agreement with Murata of Japan to build lathes and other machines to their specifications. Caterpillar Tractor Company is involved in a joint venture with Mitsubishi Heavy Industries Ltd. to manufacture hydraulic excavators. Caterpillar has recently unveiled a new line of bulldozers and diesel locomotive engines.

Unprofitable operations and continuing pressure from imports have led to several plant closings and consolidations. Nearly one-half of all U.S. machine tool companies now import either components or complete machine tools in an effort to cut costs and become more price competitive. Indeed, machine tool makers, Cross & Trecker and Ex-Cell-O, are in the midst of closing plants to reduce production capacity and are improving the overall efficiency of their operations. Many U.S. companies also supply the needs of third markets from their overseas manufacturing subsidiaries. Lift-truck makers Yale Materials Handling Corporation and Hyster Company rely heavily on offshore production. However, the weakening U.S. dollar relative to the yen and other foreign currencies should help nonelectrical machinery export sales and stem the severe price-cutting wars within the industry. Hale Fire Pump Company has increased its overseas sales force as export orders picked up this year. Cincinnati Milacron Inc., the nation's largest machine tool concern, is slowly gaining market share and reports that orders are up 11 percent from a year ago.

Demand from the auto and defense industries should remain strong in 1987. The continued trend towards automation will increase the demand for machine tools linked by computer control. Similarly, the demand for robots should continue to grow. Over 20 percent of crane builder Harnischfeger's customers increased orders for automated factory systems. Technology will remain a key factor as the industry continues to search for even more efficient applications of the computer to machines and industrial processes.

Sales of U.S. farm machinery will continue to sag in 1987 as depressed commodity and land prices reduce demand. Only two major farm tractor producers, Deere & Company and J.I. Case, remain as major producers in the U.S. industry, down from seven in 1982. Most farm equipment companies have made substantial cost reductions in all of their production and management operations, while others have either closed down plants or left the business altogether. International Harvester Company (now Navistar) has sold its troubled farm equipment unit to Tenneco. As a result of this industry restructuring, production of farm equipment should rise by 3.3 percent in 1987.

For the nonelectrical machinery industry as a whole, production is anticipated to rise by 5.7 percent in 1987. Industry employment is expected to increase only slightly in 1987, after a projected decline of 3.6 percent this year.

Computers

The U.S. office equipment industry has enjoyed substantial expansion in recent years, with output growth increasing by over 13 percent per annum since the beginning of the recovery. Although its prospects remain good, many of the sectors within the office equipment industry have undergone significant changes.

The production of office equipment is anticipated to rise by 7 percent next year. This compares to a 21 percent increase in 1984, when the famous high-tech Silicon Valley area was a strong source of new jobs and new companies. However, in the last two years, signs of a slowdown have become evident. Electronics companies are facing saturated markets and mushrooming foreign competition. As a consequence, industry employment is anticipated to grow by only 4.1 percent in 1987. So far this year, Wang laid off 1,600 workers; Data General dismissed 1,050

employees; and Apollo slashed payrolls by 300 workers. Dozens of companies have forced employees to take pay cuts and pay freezes, unpaid vacations, early retirement, and four day workweeks in an attempt to reduce payrolls and inventories. Such factors as overcrowded markets, excessive domestic production costs and severe import competition are structural problems that will affect the industry's outlook next year.

The improvement in the outlook for the computer industry depends, in large part, on the declining value of the dollar. Already, computer makers have reported a surge in export sales. Prime Computer Inc. attributed 30 percent of its first half earnings to the declining dollar. Computer manufacturer Hewlitt Packard has taken advantage of the cheaper dollar to slash its European and Japanese selling prices by as much as 30 percent. This has resulted in a 51 percent increase in export sales for the first 9 months of 1986. Although IBM's U.S. sales may be flat, the company reports that overseas sales are running 20 percent ahead of last year. In an effort to remain competitive, computer equipment manufacturers have established their production facilities offshore, not only to serve foreign markets but also to produce goods for the U.S. market. Corona Data Systems, a desktop computer maker, has cut costs by 42 percent since it moved production facilities to South Korea and Japan.

While the sales growth of personal computers is abating, demand for computer work stations—extra powerful personal computers for engineers, scientists and other professionals—has increased. The minicomputer market, however, has been squeezed by cutbacks in corporate computer buying and the spread of desktop office computers. Growing interests by consumers in the educational and home computer markets will contribute to the growth of personal computers. In an effort to remain competitive, companies are introducing new models of business computers, developing new market strategies and reducing prices in hopes of increasing sales. Honeywell is among the many computer concerns turning to so-called "vertical marketing," tailoring sales efforts to the special needs of different industries. Digital Equipment Corporation has spent two years overhauling its aging line of minicomputers; as a result, sales rose by 14 percent in 1986. Texas Instruments is focusing on advances in artificial intelligence and industrial automation.

Electrical Machinery

The near term outlook for the electrical machinery industry calls for modest growth in 1987. Industrial output and employment is anticipated to increase by 5.3 percent and 0.4 percent, respectively.

Although within the industry there were bright spots in the defense and consumer products categories, depressed sales in the industrial components sector, especially semiconductors, dragged down overall industry performance. Semiconductors, which made the greatest contribution in technical and economic terms to the industry, have suffered a sharp turnaround from its spectacular advance in 1984. It continues to suffer from reduced demand, depressed prices, high inventories and excess capacity. Foreign competition, especially from Japan in high-volume semiconductor segments, has pushed import penetration ratios as high as 39 percent of the U.S. market. However, in July, the U.S. concluded a trade agreement on semiconductors with Japan designed to cut Japanese dumping and increase the U.S. share of the Japanese chip market. Indeed, National Semiconductor Corporation recently signed an agreement with NMB Semiconductor Company, a Japanese chipmaker, to design, make and sell computer chips in Japan. And, Texas Instruments and Motorola are among the first to have built electronics plants in Japan.

In an effort to solidify their presence in the U.S. market and guard against the possibility of protectionist policies, Japanese producers are increasing joint ventures with U.S. firms. Several Japanese electronics firms have announced plans to acquire U.S. concerns, to expand U.S. operations, or start new product lines at existing U.S. plants. Mitsubishi Metal Corporation, a Japanese producer of semiconductor equipment, plans to acquire California-based Siltec Corporation in order to expand production of silicon wafers. In May, NEC Corporation, a Japanese electronics firm, finished construction of a fiber optics facility near Portland, Oregon. And, Matsushita Electric Industrial Company, Japan's largest electronics firm, plans to build two plants in the U.S., one in Washington and another in Georgia.

Demand from the defense, telecommunications, and aerospace industries should prove strong in 1987, igniting the broad and gradual recovery in the electronics industry. A strong consumer sector should support demand for household appliances; however, some categories, such as T.V. and radios will continue to face severe import competition. Although the dollar's decline relative to the yen will result in higher prices for Japanese products (Sony Corporation recently raised prices by 5 percent on its entire line of color T.V. sets), and lower imports from Japan, imports from newly industrializing countries, such as South Korea, whose currency is linked to the dollar, will rise.

Transportation Equipment

In the years following the 1979 energy crisis, the combination of a major shift in consumer demand, sluggish economic conditions and intense foreign competition plunged the transportation equipment industry into the worst crisis in its history. Three problems in particular—high U.S. labor costs, uncompetitive product quality, and shortcomings in management practices—placed domestic

producers at a serious disadvantage in relation to their Japanese counterparts. In responding to these critical challenges, the industry has made dramatic changes which include restructured product lines, modernized factories, and streamlined production processes. In doing so, it has increased productivity, reduced costs and improved product quality. Between 1978 and 1986, the domestic industry invested over $84 billion in new plant and equipment.

The transportation equipment sector tends to be one of the most cyclical sectors in the U.S. economy and, as a result, it has benefited significantly from the economic expansion. Industry production is projected to increase by 2.1 percent in 1987. The motor vehicles sector is expected to post a slower rate of growth next year while the production of aircraft and railroad equipment should enjoy substantial increases. The aircraft industry is anticipated to increase production by 8 percent in 1987 as airlines expand capacity in efforts to compete for traffic volume.

Long-term industry growth will largely be determined by the degree of success in implementing new technologies designed to speed up production and reduce costs. A majority of the industries comprising the transportation sector continue to face intense foreign competition. Car makers, in an effort to remain competitive with Japanese producers, are adding new high-tech companies to help link design and engineering with production. They are also expanding financial services to facilitate marketing and sales of domestic cars. Domestic car sales are expected to average close to 8 million units next year. However, sales of imported cars are projected to be near 3 million units, accounting for 29 percent of the U.S. market. Although U.S. car sales reached high levels in the summer of this year because of the subsidized interest rates on car loans, the sales promotion was expensive and hurt the earnings of automakers as sales volume did not completely offset costs.

The U.S. auto industry is undertaking new product development and plant modernization of unprecedented scope to regain international competitiveness. They are also engaging in a host of mergers and joint ventures with foreign producers. General Motors Corporation and Sweden's Volvo recently decided to pool their heavy truck operations and form a new company: Volvo GM Heavy Truck Company. As in the electrical machinery sector, foreign automakers are also setting up production facilities in the U.S. General Motors Corporation and Toyota Motor Corporation have formed a joint venture to produce subcompact Novas for Chevrolet in California. Other Japanese automakers that have established production facilities in the U.S. are: Honda Motor Company, Mazda Motor Company, Isuzu Motors Ltd. and Nissan Motors Corporation.

The decline in the value of the dollar has already resulted in price increases for foreign made cars, further increasing the domestic industry's competitiveness. Japanese car makers have boosted prices by an average of $1,027 a car for the 1987 model year. As a result, the inventory of unsold Japanese cars in the U.S. surged by nearly 62 percent at the end of August, compared to a year earlier. Honda Motor Company announced its fourth price increase (4.4 percent) for the 1987 model cars. Volvo also plans to increase prices by 4 percent, but this will depend on the strength of the German mark relative to the dollar because many of the parts used by the Swedish manufacturer are made in Germany.

Moreover, the decline in oil prices is likely to increase the demand for larger automobiles and recreational vehicles, an area where the U.S. still holds a comparative advantage. Compact vans and pickups have retained their popularity because of improved fuel efficiency and their load carrying ability. The U.S. trucking industry, which hauls about 75 percent of the nation's goods, projects that lower diesel fuel costs will save it $7.7 billion next year.

Instruments

The instruments industry, consisting principally of scientific and industrial measurement equipment and consumer products such as cameras, continues to be one of the more profitable manufacturing sectors. Instruments are of major importance in the manufacturing process as they reduce inefficiency and increase both the quantity and quality of the products. Traditionally, the market for instruments reflects the overall level of capital investment in plant and equipment, in combination with the amount spent on research and development (R&D). While the rate of growth in capital investment slowed in 1986, spending on R&D has continued to increase. The trend toward integrating computer technology with instrumentation should continue next year, along with increases in private and public R&D spending.

The continuation in the downward trend in the value of the U.S. dollar and its impact on exports has been a positive development for this industry for which foreign markets, especially in East Asia and Japan, are an important source of revenue. Indeed, the lower value of the dollar has increased export sales at Polaroid by over 40 percent so far this year.

Industry production is expected to increase by 5.2 percent next year, after a projected rise of 2.3 percent in 1986. Workforce reductions over the past few years have contributed to reduced costs. As a result, employment growth is expected to remain flat next year, after rising 0.4 percent this year. Factors that continue to moderate industry growth next year include slow economic growth in our major trading partners, severe liquidity problems that have reduced capital expenditures in developing countries, and the increasing competitiveness of Japanese and European manufacturers.

Food and Products

Changing consumer tastes, demographic shifts and slow population growth signal significant shifts in the structure of the food and products industry over the next few years. Industry production is anticipated to increase by 4.2 percent next year, significantly above the average for nondurable manufacturing as a whole. Many companies are specializing in product lines with high value-added convenience foods whose demand has risen in step with rising consumer incomes and two-earner households. In general, branded products which enjoy strong consumer loyalty have gained market shares, while private-label and generic products have lost shares in virtually all categories.

Increasingly, mergers and acquisitions are changing the character of the American food industry. Last year, the $200 billion a year industry experienced some of the largest takeovers in American corporate history. R.J. Reynolds paid $5 billion for Nabisco Brands; Phillip Morris acquired General Foods for $5.8 billion; and there was a $6 billion leveraged buyout of Beatrice Companies. Other food industry firms were also active in seeking growth by diversification.

Reflecting improving economic conditions and efficiencies accruing from consolidation and concentration, food industry profits will continue to increase in 1987. At many companies, profits were helped by lower commodity prices and interest rates, but hurt by high advertising costs. Earnings on highly processed and specialty foods generally rose, while meat processors' earnings were squeezed by low consumer demand and depressed prices. In today's deflationary environment, food companies are finding it harder to maintain margins by raising prices.

Many companies have already begun to benefit from the decline in the value of the dollar. CPC International, which earns 50 percent of its revenues from abroad, has reported an increase in food export sales for this year. Traditionally, the U.S. has been a net exporter in this industry; however, the surplus is slowly being eroded. After declining by a projected 9 percent this year, exports of food and products are expected to increase by 7.7 percent next year. Imports are anticipated to decline by 1.2 percent in 1987. The U.S. is an importer of high-value-added products, including alcoholic beverages, confectionary products, processed fruit and vegetable products and bakery goods.

Tobacco Products

Continuing public interest to discourage the use of tobacco products, anticipated price increases, and a decline in the number of young people reaching smoking age are expected to further depress the consumption of tobacco products in the next few years. Moreover, the future rate of the Federal cigarette excise tax remains unclear. Given these prospects, cigarette makers are expected to compete aggressively for market share through the introduction of new products and price-related promotional campaigns. In addition, tobacco product manufacturers are likely to seek further industry acquisitions and mergers to offset consumption-related revenue declines. As a result, industry production should show a 0.2 percent decline next year, after falling 2.3 percent this year. Nevertheless, profits have increased substantially this year. Aided by higher cigarette prices and lower unit costs, R.J. Reynolds reported a 21 percent gain in profits in the second quarter of 1986.

In an effort to offset weakening demand, cigarette manufacturers are increasing new product development efforts, acquiring other companies and are experimenting further with price-segmentation techniques. Last year, major developments occurred in the lower priced cigarette segment as the demand for generic cigarettes increased. The Brown and Williamson Company has introduced a new line of generic cigarettes and joined Ligget and Meyers in developing the lower priced market segment. Phillip Morris has introduced a new product whose filter regulates the amount of tar delivered. Product innovations also include longer cigarettes and products positioned to appeal to special market segments such as women and low-tar smokers. Manufacturers have also been developing the emerging value-added market segment; value-added packages contain 25 cigarettes but retail for the price of a 20-count package.

Cigarettes are the major export of the U.S. tobacco industry. The quantity and value of U.S. cigarette exports rose annually through 1981 and then began to decline because of the growing strength of the U.S. dollar and import restrictions abroad. Next year, however, with the lower value of the dollar boosting sales in foreign markets and the reduction in the Japanese tariff, tobacco exports could increase by over 30 percent. On the import side, while foreign suppliers, particularly of cigars and snuff, are making gains in the U.S. market, imports should rise by 2 percent in 1987.

Textile and Apparel Products

The economic fortunes of the U.S. textile industry are closely tied to those of apparel manufacturers. U.S. textile firms sell 50 percent of their output to domestic apparel makers and, in many cases, textile firms also have apparel operations. Overburdened inventories at the retail and wholesale levels, continued increases in imports, as well as sluggish consumer demand, contributed to the sharp drop in industry shipments in 1986. Since 1980, these two industries have reduced employment by over 200,000 jobs and closed over 250 textile mills.

Both the apparel and textile industries have undergone a massive restructuring in an effort to increase both foreign and domestic competitiveness. This has been achieved through the use of "sourcing"—engaging suppliers outside the firm to furnish some or all components at various stages of the manufacturing process. To further increase competitiveness, firms have implemented technological improvements such as the extensive use of computers and better cost control. The traditional ring spinning for yarn, for example, has been supplanted by rotor and friction spinning, which has increased productivity tenfold. Hartmarx Inc., an apparel manufacturer, has begun testing an automated sewing machine which reduces the time spent handling fabric.

Textile and apparel producers have also scrambled to consolidate and shed product lines where they can no longer compete with foreign producers. Industry mergers and acquisitions have allowed firms to concentrate on particular segments of the market. Springs Industries Inc. recently acquired Lowenstein Corporation, thereby creating the second largest U.S. textile enterprise which will specialize in bedsheet production. Cannon Mills Company was acquired by Fieldcrest Mills Inc. in order to strengthen its linens and domestic fabrics division. J.P. Stevens and Company is eliminating its apparel fabrics division in favor of industrial and domestic textiles such as draperies and rugs where substantial growth opportunities exist. And, Collins & Aikman Corporation is concentrating on market niches where imports are vulnerable, such as automotive carpeting and upholstery. Domestic manufacturers are also competing well in the high fashion apparel business which undergoes rapid change. By offering shorter lead times and better quality control than foreign suppliers, domestic firms have sharply improved their competitive edge. The industry is also continuing its $13 million "Buy American" advertising campaign next year.

As a result of these efforts, textile production should increase by 2.3 percent in 1987. Employment is also expected to increase by 2.2 percent next year. Output and employment in the apparel sector is also anticipated to improve in 1987, albeit at a slower pace than textile production. Average hourly earnings in both industries are well below the national average.

The decline in the value of the U.S. dollar is not expected to boost textile and apparel sales significantly since the currencies of the major foreign suppliers of these products (Taiwan, South Korea, Hong Kong, and China) to the U.S. have depreciated an average of only 5 percent against the dollar. U.S. exports of textiles and apparel have suffered and imports have gained, resulting in a 17 percent increase in the industry trade deficit in the first half of 1986 from the same period in 1985.

Paper and Products

Propelled by strong demand, high operating rates and improved earnings, paper producers are expected to increase their capital spending plans in 1987. Responding to tight markets, several companies are in the process of purchasing new machines as well as several new mills. Great Northern Nekoosa Corporation is boosting capacity in its containerboard plants, which have already been operating at 90 percent of capacity for the past two years. Aided by enhanced productivity, the benefits of cost-cutting measures initiated during the recession, and the inherent economies accruing from high operating rates, industry profits should increase further in 1987. Although consumer demand for paper products will not contribute much to industry performance, brisk expansion in business demand should result in increases in production and employment during 1987 of 3.7 percent and 0.7 percent, respectively.

The increase in output, however, will not be uniform among the industry's subsectors. Some segments of the industry, such as uncoated free sheet and linerboard have experienced price weakness and severe competition from imports. However, producers of coated paper and the uncoated free sheet used for computer printouts and copiers will continue to enjoy steady growth. Paper producers are continuing efforts to cut costs and many are converting mills that once produced commodity grades of paper to make higher-margin products. Georgia-Pacific Corporation has converted two facilities that once made market pulp to now produce bleached papers, linerboard and tissue. The largest growth potential for the industry lies in areas such as diapers and sanitary papers, where prices are stabler and demand outruns supplies.

Demand for containerboard, newsprint and business papers is rising rapidly, in part due to increases in overseas orders. Union Camp Corporation reports that its linerboard shipments to Asia and Europe doubled in 1986. Stone Container Corporation finds that exports of linerboard are 60 percent higher than they were a year ago and sales of plywood and logs to Japan and China are also rising. At the same time, imports have begun to recede. For example, imports of printing and writing paper, mainly from Scandinavia and Latin America, declined by 22 percent in the first half of 1986 compared to the same period in 1985.

The problems plaguing the industry's growth, however, will continue for several years. Foreign producers (Brazil, Chile, Spain and Portugal) have developed sizable paper industries of their own, and increased their share of the world market. New materials are also invading the market. Polyethylene plastic is rapidly replacing unbleached kraft paper for sacks. Other market losses have resulted from the increasing use of telecommunication devices that transmit information electronically. Nevertheless, the U.S. is the largest producer of primary paper and products, producing over 35 percent of the world's total supply. The industry continues to be in an excellent position

to serve its domestic market and to compete aggressively in foreign markets.

Printing and Publishing

The U.S. printing and publishing industry is the largest in the world, comprising 53,000 establishments and employing 1.3 million people. The demand for U.S. printed products rests on a number of demographic and economic factors, but particularly on business confidence, as evidenced by advertising expenditures and gains in disposable income. Other factors include population growth, household formation, educational attainment and increased personal consumption expenditures. In view of the favorable outlook of these factors, industry output are expected to grow at an average rate of 3.6 percent in 1987, following an estimated 2.9 percent rise in 1986. Sales of printed products should rise next year, with the increase being led by advertising in newspapers and magazines.

Technological change has affected virtually every phase of the industry's operations, thus increasing efficiency in production and delivery. Productivity increases are especially noticeable in typesetting and pre-press operations of many newspaper and commercial printing firms. Investment in equipment and machinery has increased production with minimal additions to payrolls. But the challenges facing the industry are many. Although the electronic media continues to make inroads on the consumers' attention, the print media have many advantages over T.V.s, videos and radios, including portability, low cost, accessibility and storage.

While the focus of most U.S. printing and publishing firms is on serving the domestic market, the industry is a net exporter of printed matter and the second largest exporter in the world behind West Germany. Shipments of printed matter destined primarily for Canada, England, Australia and Japan are expected to total $1.5 billion in 1987.

Chemicals and Products

The chemical industry is expected to outperform most other nondurable manufacturing industries next year as industrial output rises by 4 percent. Employment should increase by only one percent as companies hold the line on payrolls in order to contain costs. The strength in the automobile, housing and defense sectors, the industry's major markets, will continue to buoy chemical production, particularly in synthetic materials, which are expected to enjoy a 6 percent increase in production next year.

Strength in the industry's key sectors (basic chemicals, synthetic materials, drugs and paint) will offset weakness in other categories such as agriculture and industrial organic chemicals. Industrial gas and epoxy resin producers that supply the automobile and textile industry should experience a 3.0 percent increase in demand in 1987. Many chemical producers have entered into new and highly specialized profitable markets. Dow Chemical is developing specialized plastics; Hercules produces graphite fibers for the aerospace industry; and Union Carbide is expanding its industrial gases division. The move into specialty chemicals has coincided with a retreat from commodity chemicals production. Dow Chemicals abandoned its polyethylene complex in Saudi Arabia and Monsanto dropped its commodity petrochemical business. Consumer demand will account for some of the industry's strength expected in 1987 as the output of both soap and toiletries is expected to rise by 3.0 percent. Next year will continue to be bleak for producers of pesticides, fertilizers and other agricultural chemicals because of the depressed state of the farm economy.

Thanks to a much stronger cash flow and stringent cost-cutting measures, the debt position of the major chemical companies is much improved. Nevertheless, companies were saddled with increased operating costs as a result of stricter environmental and safety rules. This year, however, there were large increases in research and development to improve efficiency and create new products, thereby increasing competitiveness in world markets. The industry has suffered from global excess supply and intensifying foreign competition, especially in basic petrochemicals as low-cost producers from Saudi Arabia and Canada penetrate traditional U.S. markets. Further, import penetration in autos, appliances, electronics, computers and apparel has reduced these industries' domestic demand for chemicals. Exports fell by an estimated 3.7 percent this year while imports continue their rapid climb, resulting in a decline in the chemical trade surplus for the fifth straight year. However, the drop in the value of the U.S. dollar should help stabilize the chemical trade situation by stimulating export sales and slowing down the rise in imports.

Petroleum Products

The petroleum industry is continuing to adjust to long-term changes in the demand for its products. Industry production is anticipated to increase by 3.3 percent in 1987 while employment rises by 3.5 percent. The number of rotary rigs in use and the number of oil and gas exploratory and development wells has fallen to the lowest levels in years. Indeed, U.S. oil and natural gas drilling activity is the lowest since 1943.

Companies continue to restructure and streamline operations in order to adjust to the long-term changes in the marketplace. All major companies are selling off assets, paring unprofitable operations, consolidating markets and adopting other cost-cutting measures. The massive restructuring has been prompted not only by the slide in

oil prices but also by such factors as the need to cut huge corporate debt loads. Energy conservation is probably the single most important factor affecting the financial fortunes of oil companies today. Moreover, imports are hurting domestic refiners who are struggling to maintain profitable production levels. Mergers and joint ventures continue to reshape the industry as firms realize it is cheaper to increase crude oil reserves via acquisitions than to engage in costly exploration and drilling. Baker International, for example, is merging its drilling businesses with Newpark. Hughes and Dresser have formed a partnership of their pumping services subsidiaries. Overall, capital spending in the industry is expected to rise about 1.3 percent in real terms this year.

The companies that have diversified outside the production and marketing side of the energy business reported large earnings this year. Mobil has been been relying on its tanker and chemical operations and Amoco, Arco and Royal Dutch are depending on their petrochemical units to earn profits.

The Independent Petroleum Association reports that U.S. crude imports of oil have increased by 69 percent this year compared to 1985. The surge in imports was in reaction to declines in oil prices which prompted a rebuilding of U.S. oil inventories. The electric utility industry is expected to see a 20 percent increase in growth next year as the industry switches from more expensive natural gas to oil. Petroleum consumption should increase by 2 percent in 1987, with the largest gains occurring in the distillate fuel oil and jet fuel categories.

Rubber Products

The rubber products industry is expected to enjoy a turnaround in output growth next year. Propelled by strong demand generated by the housing, appliances and auto markets, the industry should see production increase by 5.6 percent in 1987. There continues to be a long-term shift away from rubber towards plastic products as they are less expensive to process. As a result, production of plastic products is expected to provide the bulk of the industry's strength, rising by 6.2 percent in 1987 while the output of other rubber products (excluding tires) rises by only 0.6 percent.

Over 70 percent of the synthetic rubber produced is consumed in the manufacture of tires and other rubber components for the auto industry. The worldwide shift to radial car tires in the early 1970s gave a new lease to the life of the natural rubber industry since radial tires require more natural rubber in their blend than do crossply tires. However, since radial tires last longer, the demand for replacement tires continues to decline. But, radial tire imports from Mexico, Brazil, Japan, Korea and other Asian countries have continued to soar, accounting for over 25 percent of the domestic market. As a result, producers are concentrating on markets for specialty rubbers (fluorocarbons, silicones, polysulfides, acrylic rubbers, and polyesters) which are increasingly being used in automotive applications.

In 1986, the industry was characterized by reduced demand, severe import competition, depressed prices and excess capacity, despite numerous plant closings in the last decade. B.F. Goodrich and Company shut two of its remaining four tire plants and abandoned production of farm tires. Firestone Tire & Rubber Company closed its Georgia factory and has phased out passenger and truck tire production. Companies continue to reshape their business in order to improve productivity, reduce costs and compete more effectively abroad. B.F. Goodrich and Company recently restructured its polyvinyl chloride and tire business in order to cut costs and streamline operations. Firestone increased earnings last year by selling its radial truck tire plant to Bridgestone Corporation, its Japanese archrival, and then buying tires made in that same factory for resale in the U.S. Manufacturers are concentrating efforts towards more profitable product lines, in particular high performance tires. Goodyear leads the industry in sales of these "upscale radial" tires to both original equipment and replacement markets. Companies are also focusing on producing specialty tires, such as aircraft tires, where imports have not yet made inroads. The recent merger of B.F. Goodrich and Uniroyal is the latest consolidation in the industry, and will account for 18 percent of the domestic market for car and light truck tires.

Prospects for the industry are expected to improve next year. The decline in the value of the dollar should bode well for domestic producers expanding into foreign markets. Although exports are projected to increase by 2.2 percent in 1987, imports will continue to climb. Lower oil prices have also proved a boon in reducing the cost of making tires and sparking more automobile travel. Demographic changes, consumer attitudes and changes in tire and transportation technology will continue to shape the future of the rubber products industry.

Leather and Products

The outlook for the U.S. leather and products industry appears brighter than it has been for years. Although the U.S. is one of the principal suppliers of leather to world markets, the proximity to raw materials has not helped the domestic fabrication industry in its struggle with foreign competition. The industry continues to be besieged by imports, which now account for 52 percent of domestic consumption of leather goods. With the exception of tanning, all sectors of the industry are labor-intensive. As a result, lower labor costs in many developing countries such as Mexico, Brazil and Taiwan, give foreign suppliers a substantial cost advantage. The developing countries' 1986 share of total U.S. imports of leather and products is expected to reach 73 percent.

The leather footwear industry, which labors under a 51 percent import penetration ratio, is composed primarily of privately held, family businesses. Despite such intense foreign competition, U.S. exports of leather footwear have enjoyed substantial increases during the past two years. The rate of growth of imports of this category of leather products has also increased but at a much slower rate than in previous years.

Although hundreds of plants have been closed during the past two years and employment has declined drastically, the remaining companies have streamlined operations, cut costs significantly and relocated some portion of production to low-cost overseas facilities. Manufacturers have also shifted production to higher-valued products and are trying to carve out market niches for themselves. Companies such as Interco have also begun diversifying into areas such as apparel and furniture in order to boost earnings.

Only the large, highly capitalized companies, however, will be able to afford investment in new technologies, especially robotics, that could narrow the disparity in labor costs between many foreign suppliers and U.S. producers. Consequently, many of the small producers will continue to be absorbed by larger firms during this period of industry consolidation and contraction. Overall production is expected to rise by 0.3 percent in 1987, after declining 8.8 percent this year. Reflecting the industry's shrinkage, total employment will fall by 5.9 percent this year but increase slightly in 1987.

LATIN AMERICAN DEBT: FLIRTING WITH DISASTER

by
Graciela Testa-Ortiz

The heavily indebted nations of Latin America are facing an insolvency crisis that cannot be resolved with IMF (International Monetary Fund) bridge loans. Today, four years after the debt problem was recognized, it remains as pressing a danger to the world's financial system as it was in 1982. In the process of complying with austerity measures designed to generate trade surpluses and earn the necessary foreign exchange to service the debt, economic growth and real wages have plunged in the Latin American nations. However, despite all the efforts, not only has the situation not improved, but IMF projections show that the problems (i.e., low economic growth rates and large debt burdens), will continue during the next five years.

The problems faced by the indebted developing countries have, so far, only been a matter of discussion in international financial and academic circles. Most Americans incorrectly believe that it is of very little relevance to them; there has been an almost complete lack of interest on the part of the American business community regarding this topic and its eventual resolution. Yet, the problems of the debtor nations have already cost many American workers their jobs and American businesses their markets. This paper details the channels through which the U.S. economy has been affected by the debt problems of our Latin neighbors and the results that have been achieved by the debt management strategy employed thus far. It then addresses the issue of default: the likelihood of it occuring and the impact it would have on the U.S. economy. The final section analyzes alternative long-range solutions to the problem.

Who Are The Indebted Nations and Why Are They So Important?

By far, the largest concentration of problem debtors is in Latin America. According to the IMF's classification, ten of the fifteen most heavily indebted nations—Argentina, Bolivia, Brazil, Chile, Colombia, Ecuador, Mexico, Peru, Uruguay and Venezuela—are Latin American republics (the remaining five nations are the Ivory Coast, Morocco, Nigeria, the Philippines and Yugoslavia). Not only does the list of Latin American debtors include all the major regional economies but, with the exception of Colombia, they all fit the IMF's definition of countries with recent debt servicing problems. That is, most of these countries have incurred debt service arrears during 1983–1984 or rescheduled their debt since 1982.

Aside from their obvious strategic importance, our Latin American neighbors have historically been an important source of demand for U.S. goods and services, ranking third in market importance behind Western Europe and Canada. The retrenchment in their economies which resulted from the debt crisis, has seriously curtailed their ability to import U.S. products, exacerbating our foreign trade gap. U.S. merchandise exports to Latin America, which accounted for 18 percent of U.S. exports of merchandise in 1981, fell to a low of 12.7 percent in 1983 during the worst of the debt crisis. Although they subsequently recovered, and as of the first half of this year averaged 13.7 percent of total exports, the ratio remains significantly below that of the first two years of the 1980s. In absolute terms, U.S. exports of merchandise to the region dropped by $12 billion between 1981 and 1985, accounting for over 50 percent of the total decline in merchandise exports during that period.

In an effort to raise the foreign exchange needed to service their mounting debts, the Latin American economies successfully increased exports. U.S. imports of merchan-

dise from Latin America rose by $7 billion between 1981 and 1985. As a result of the decline in Latin American imports from the U.S. and the increase in their exports to this country, the U.S. merchandise trade balance with the region swung from a $3.7 billion surplus in 1981 to a $15.3 billion deficit in 1985. Trade in services, where the U.S. has historically enjoyed a comfortable surplus, was also affected. The balance on services trade with Latin America fell from a $17.5 billion surplus in 1981 to $8 billion in 1985 (see Table 1).

TABLE 1

U.S. TRADE WITH LATIN AMERICA

($ Billions Unless Otherwise Noted)

	1980	1981	1982	1983	1984	1985
EXPORTS						
Merchandise						
Total	224.3	237.1	211.2	201.8	219.9	214.4
Latin America	38.8	42.8	33.2	25.6	29.8	30.8
(% of Total)	17.3	18.1	15.7	12.7	13.6	14.4
Services						
Total	118.2	138.7	137.5	131.4	140.2	144.1
Latin America	28.0	37.1	37.9	32.1	34.5	32.2
(% of Total)	23.7	26.7	27.6	24.4	24.6	22.3
Memorandum: Exports of Goods and Services to Latin America	66.8	79.9	71.1	57.7	64.3	63.0
IMPORTS						
Merchandise						
Total	249.8	265.1	247.6	268.9	332.4	338.9
Latin America	37.5	39.1	38.6	42.8	48.4	46.1
(% of Total)	15.0	14.7	15.6	15.9	14.6	13.6
Services						
Total	83.2	96.9	101.3	101.5	122.0	122.3
Latin America	15.5	19.6	23.5	21.3	26.6	24.2
(% of Total)	18.6	20.2	23.2	21.0	21.8	19.8
Memorandum: Imports of Goods and Services to Latin America	53.0	58.7	62.1	64.1	75.0	70.3

Source: U.S. Department of Commerce, *Survey of Current Business*, various issues.

While part of the decline in U.S. exports to this region can be explained by the appreciation of the U.S. dollar, which reduced the competitiveness of U.S. exports worldwide, this performance is particularly worrisome because it represents a sharp reversal of the previous trend. Between 1978 and 1981 merchandise exports to Latin America rose by 94.3 percent, one-and-a-half times faster than exports to the rest of the world. Since 1981, however, exports to Latin America have fallen four times faster than exports to the rest of the world.

The decline in exports to Latin America has affected some U.S. industries (which were already badly hurt by recession and the high value of the dollar) particularly hard. For instance, U.S. exports of machinery to Latin America, which reached $12.3 billion in 1981, averaged only $8.7 billion in 1985, a 29 percent decline. Similarly, exports of transportation equipment have declined by $2.3 billion (43 percent) since 1981, and iron and steel exports fell by $0.7 billion (70 percent). The decline in exports encompasses agricultural as well as nonagricultural trade. Sales of farm commodities to Latin America declined by $1.9 billion (33 percent) between 1981 and 1985 (see Table 2).

These declines in sales to our indebted Latin neighbors have translated into lost jobs. According to a 1983 study by Lester A. Davis, $1 billion in U.S. exports represented an average of 25,200 jobs in 1982. On that basis, the decline in exports of manufactures to Latin America since 1981 resulted in a loss of 302,400 jobs. More recently, University of Pennsylvania Professor F. Gerard Adams estimated that the swing in trade with Latin America cost the U.S. 780,000 jobs in 1984. Many of those jobs are in exactly those industries which were worst hit by the 1982 recession and the high value of the dollar.

Managing the Debt Problem: The Evidence So Far

Unfortunately, the debt crisis is far from being resolved despite the fact that the debtors have generally complied with IMF-sponsored austerity programs. What has re-

TABLE 2

U.S. EXPORTS TO LATIN AMERICA
BY COMMODITY GROUPINGS
($ Billions Unless Otherwise Noted)

	1980	1981	1982	1983	1984	1985	Percent change 1981-85
Agricultural commodities	5.7	5.8	3.9	4.6	4.7	3.9	-32.8%
Nonagricultural commodities	29.7	32.4	25.2	17.4	20.8	23.1	-28.7%
Food & Animals	4.5	4.7	2.8	3.6	3.0	2.6	-44.7%
Chemicals	4.9	4.5	3.7	3.3	3.8	3.7	-17.8%
Manufactured goods	4.4	4.7	3.2	2.1	2.4	2.5	-46.8%
Iron & Steel	1.1	1.0	0.6	0.3	0.3	0.3	-70.0%
Machinery	10.6	12.3	9.7	8.2	10.0	8.7	-29.3%
Transportation equipment	4.6	5.4	3.3	2.0	2.3	3.1	-42.6%

Source: U.S. Department of Commerce, *Highlights of U.S. Export and Import Trade*, various issues.

sulted from the strategies followed so far is significant in the negative impact that they have had on the economies of the debtor nations. In 1983, there was an outflow of capital from the indebted countries to their creditors in the West. According to the IMF's own projections, moreover, this perverse flow will continue into the 1990s, but the burden of debt will not be significantly lower. In the meantime, standards of living have fallen dramatically in the indebted nations.

Economic austerity is never a politically palatable option. The political pressures that rising unemployment and falling living standards create could topple any government, but particularly the fledging Latin American democracies. Most of those governments accepted these measures in the belief that they would be short-lived. That is, they expected that in the years following the initial crisis, international economic conditions would improve to the point where they would be able to increase exports to get their economies moving again, and relax the stringent measures. But, although interest rates have declined, relief is not forthcoming because, with the exception of the United States, industrial country imports from Latin America have remained low, commodity prices have not increased significantly, and protectionism has risen.

Although economic activity has recently picked up in West Germany and Japan, the U.S. is, far and away, the major market for Latin American products. Even while U.S. economic growth during the past year-and-a-half fell below initial expectations, the U.S. share of Latin American exports rose from 47 percent in 1985 to 52 percent during the first half of this year. But, while U.S. imports from Latin America have risen since the onset of the debt crisis and are now higher than they were in 1981, they slackened during the past year-and-a-half even while imports from other regions continued rising. Total U.S. merchandise imports rose by almost 12 percent between the first quarter of 1985 and the first quarter of 1986, but imports from Latin America fell by 5.2 percent. Other industrial countries are not picking up the slack. The share of Latin American exports going to Japan and Western Europe remains very low. And, West German data indicates that that country's imports from the developing countries fell by 15.2 percent during the first half of 1986 compared to a year earlier. Moreover, world commodity prices remain weak, reducing the earnings potential of Third World exports. And finally, industrial country protectionism has actually increased, albeit modestly. According to the World Bank, the share of developing country imports subject to nontariff barriers in industrial country markets rose from 19.5 percent in 1981 to 20.6 percent in 1984.

As a consequence of these many factors, the economic performance of the indebted less developed countries (LDCs) has been disastrous. Following the IMF's prescriptions, the problem debtors attempted to correct both the internal imbalances (budget deficits), and their external imbalances (trade deficits), by reducing (public or private) spending to free resources to pay their debts. This was accomplished through cuts in public spending and tax increases to reduce the fiscal deficit, and increases in exports and reductions in imports to reduce the trade deficit. To increase the external competitiveness of exports, the indebted countries allowed their currencies to depreciate. However, this made imported products more expensive in domestic markets and increased inflationary pressures. This was exacerbated by rapid increases in the money supply to finance continuing budget deficits. The result has been sharp increases in inflation and concomitant declines in real wages. In most LDCs, both growth in the money supply and inflation reached peak rates in 1985 (see Table 3). "In sum," comments MIT Professor Rudiger Dornbusch, "the needs to generate a large trade surplus and to finance large budget deficits combined to create inflationary recessions, cuts in real wages and the standard of living, unemployment, and severe cutbacks in investment."

Thus, while the industrial countries went into recession in 1982 and real GDP growth decelerated in the capital importing developing countries, real economic activity fell, both in 1982 and in 1983, in the most heavily indebted LDCs. In per capita terms, real GDP in the developing countries declined in 1981, 1982 and 1983, and in the fifteen most heavily indebted nations the decline continued into 1984. While 1985 brought a respite, 1986 promises to be another year of declining output and 1987 projections are for continued stagnation. In other words, per capita output in the indebted nations has been declining since the debt crisis began and there seems to be no relief in sight. Moreover, there has been a dramatic decline in the share of investment in GNP, further impairing prospects for future growth (see Table 3).

Yet there has been very little improvement in the external debt situation. Total external debt and debt service payments as a proportion of exports continued to rise during 1983–1985. The only significant improvement has been a sharp reduction in the share of short-term debt to total debt (see Table 4). However, all this means is that the day of reckoning has been postponed. A recent report by Morgan Guaranty Trust Company notes that, in the case of Brazil, recent debt reschedulings mean that its debt obligations will fall due at a rate of $10 billion a year between 1987 and 1989. The report concludes that, "By any reasonable standard, the present maturity schedule cannot be met."

The prognosis is not very good. In a rather too self-congratulatory manner, the IMF staff concludes, in its latest *World Economic Outlook*, that the measures instituted to manage the debt crisis "have had beneficial results, in terms of both strengthening the balance of payments and

TABLE 3

INDICATORS OF REAL ECONOMIC ACTIVITY

(Percent change except where noted)

	Average 1968-77	1978	1979	1980	1981	1982	1983	1984	1985	1986	1987
Real GDP											
Industrial countries	3.5	4.2	3.3	1.2	1.4	-0.4	2.6	4.7	2.8	3.0	3.2
Capital importing LDCs	5.7	5.7	4.8	4.7	3.0	2.1	1.6	4.7	4.2	3.5	4.2
Western Hemisphere	6.0	4.1	6.0	5.3	0.9	-0.9	-3.1	3.1	3.8	1.6	3.5
Countries with recent debt servicing problems	5.6	3.5	5.4	4.6	1.2	-0.1	-2.5	2.6	2.8	1.9	3.3
15 Heavily indebted countries	6.4	3.4	6.1	4.8	0.7	-0.4	-3.5	2.2	3.1	1.5	3.3
Per capita GDP											
Capital importing LDCs	3.2	3.0	2.2	2.4	0.9	-0.3	-0.7	2.2	2.0	1.1	1.7
Western Hemisphere	3.6	1.1	3.7	3.0	-1.2	-3.2	-5.3	0.8	1.7	-0.6	1.3
Countries with recent debt servicing problems	3.3	0.8	3.1	2.2	-0.1	-2.5	-4.8	0.2	0.6	-0.5	1.1
15 Heavily indebted countries	3.9	0.6	3.7	2.6	-1.5	-2.8	-5.6	-0.2	1.0	-0.7	1.1
Broad Money Aggregates											
Industrial countries	n.a.	11.2	10.6	9.5	10.0	9.4	10.5	7.7	8.9	7.7	7.4
Capital importing LDCs	n.a.	29.6	35.5	27.0	27.9	17.3	10.1	10.6	7.7	n.a.	n.a.
Western Hempisphere	n.a.	53.3	60.9	53.4	71.3	73.2	104.2	141.5	143.1	n.a.	n.a.
Countries with recent debt servicing problems	n.a.	38.8	42.1	43.4	51.7	51.9	69.4	92.0	91.5	n.a.	n.a.
15 Heavily indebted counties	n.a.	45.1	51.8	50.5	60.9	61.6	88.1	117.7	120.6	n.a.	n.a.
Consumer Prices											
Industrial countries	7.1	6.9	9.2	12.1	9.9	6.9	4.4	4.4	3.8	2.6	2.7
Capital importing LDCs	15.2	18.7	21.5	27.1	26.0	24.5	32.7	37.4	39.3	25.9	13.7
Western Hemisphere	27.9	41.9	46.5	54.2	59.1	66.3	102.4	122.6	144.0	76.0	27.0
Countries with recent debt servicing problems	20.5	31.2	34.4	39.6	44.6	46.6	70.3	85.1	93.3	55.1	23.3
15 Heavily indebted countries	25.7	37.4	40.8	47.0	52.6	56.0	87.5	110.6	122.5	68.1	25.9
Gross Capital Formation											
(as a percent of GDP)											
Capital importing LDCs	n.a.	28.0	27.1	24.4	26.0	26.4	31.2	29.3	28.0	25.5	n.a.
Western Hemisphere	n.a.	24.7	23.0	23.4	22.8	20.9	17.4	17.2	17.9	17.4	n.a.
Countries with recent debt servicing problems	n.a.	27.2	25.6	25.4	25.3	22.6	19.1	18.0	18.0	17.5	n.a.
15 Heavily indebted countries	n.a.	27.0	24.9	24.7	24.6	22.3	18.3	17.2	17.2	16.8	n.a.

Note: For a definition of the countries included in each group, see footnotes to Table 4.
Industrial countries is average of seven major countries: Canada, U.S., Japan, France, West Germany, Italy and the U.K.

Source: International Monetary Fund, *World Economic Outlook, 1986*, Tables A5, A6, A7, A11, A13, A18 and A53.

the debt structure of the capital importing countries, and limiting the extent of the setback to domestic growth." But Fund projections show that, even under the best of circumstances, the problem is far from resolved. Table 5, which is entirely derived from IMF data, clearly shows that, not only will the debt burden of the major debtors remain threateningly high through the end of this decade, but, more menacingly, that the perverse transfer of capital from the poor countries to the industrialized West will continue.

In the case of the Western Hemisphere countries, the table shows that by 1991, net new capital inflows will fall short of interest payments by $18.7 billion, an improvement from the 1984 peak outflow of $27 billion but hardly a satisfactory result. The transfer of funds from the fifteen most heavily indebted nations, which is implied from the IMF data, paints an even more alarming picture. After peaking at $29 billion in 1985, the transfer of capital from this hard-pressed group of countries falls slightly through 1987 but rises again in the closing years of the decade (see Table 5).

More importantly, however, the IMF projections are

TABLE 4

INDICATORS OF EXTERNAL DEBT DEVELOPMENTS

(Percent)

	1973–74	1975–78	1979–80	1981–82	1983–85
External Debt (1)					
All capital importing countries (2)	95.8	120.1	115.4	135.7	158.2
Western Hemisphere (3)	139.8	187.6	190.3	238.0	285.3
Countries with recent debt servicing problems (4)	112.1	154.4	155.9	207.4	252.4
15 Heavily indebted countries (5)	123.9	169.2	173.7	231.3	280.1
Debt Service Payments (1)					
All capital importing countries (2)	12.7	16.7	18.1	22.1	23.0
Western Hemisphere (3)	21.5	33.3	36.3	45.4	43.2
Countries with recent debt servicing problems (4)	16.7	24.5	26.5	34.8	35.5
15 Heavily indebted countries (5)	18.2	28.6	32.0	43.2	42.6
Share of Short-term Debt in Total Debt					
All capital importing countries (2)	7.3	14.3	18.6	20.8	15.3
Western Hemisphere (3)	6.3	13.1	21.3	24.4	15.3
Countries with recent debt servicing problems (4)	10.0	15.1	20.2	23.5	15.8
15 Heavily indebted countries (5)	7.1	13.8	21.7	25.3	15.7

(1) As a percentage of exports of goods and services.
(2) Includes all developing countries except Iran, Iraq, Kuwait, Libya, Oman, Qatar, Saudi Arabia and the United Arab Emirates.
(3) Thirty-three Western Hemisphere countries which account for 40.6% of the total outstanding debt of the capital importing LDCs.
(4) Defined as those countries which incurred external payments arrears during 1983 to 1984 or rescheduled their debt during the period from end-1982 to mid-1985. It includes 61 countries whose share of the total debt outstanding of all capital importing countries is 62.2%.
(5) Includes Argentina, Bolivia, Brazil, Chile, Colombia, Ivory Coast, Ecuador, Mexico, Morocco, Nigeria, Peru, Philippines, Uruguay, Venezuela and Yugoslavia. These countries are responsible for 47.1% of the total debt outstanding of all capital importing countries.

Source: International Monetary Fund, *World Economic Outlook, 1986*, p. 88, Table 19.

based on rather optimistic assumptions. These include a continuation of moderate growth rates in the industrial countries; declines in real interest rates; improvements in the world price of nonoil primary commodities; a 3 percent increase in private lending to the capital importing countries; and increases in foreign direct investment in the LDCs. The indebted countries are also expected to continue to enact policies geared toward reducing internal and external imbalances.

The IMF projections show that the indebted LDCs will have to manage a very substantial reduction in their current account balances as a proportion of exports of goods and services. As Table 6 shows, the current account balance will need to decline to a proportion which is significantly below the historical average.

One must wonder how reasonable are the IMF's assumptions, particularly at a time when protectionist pressures appear to be a major threat to world trade. The projections assume that the indebted countries' exports and imports will both rise during 1986-1991, allowing for moderate increases in total output. But, these nations' ability to compete internationally, as reflected in movements in their terms of trade (the ratio of export prices to import prices) has eroded significantly since 1982, and the IMF anticipates further declines in 1988-91. The indebted LDCs also face the problem of rising competition from the Asian developing countries who have been able to carry similar debt burdens thanks to economic growth strategies based on open, free-market economies which have promoted export growth.

Therefore, if the indebted LDCs are unable to increase exports because of lackluster growth in the industrial nations, and/or continued (or increased) protectionism, and/or the continuing deterioration in their terms of trade, the only way they will be able to achieve the hoped-for reduction in their current account deficit is through further drastic reductions in imports. But imported inputs, particularly imports of capital equipment and new technology, are of paramount importance to the development strategies of the LDCs. Without a resumption of import growth, therefore, investment will continue to decline, their economies will continue to stagnate and the standard of living of their residents will continue to slide. The other side of the coin, of course, is that they will be unable to resume their role as an important source of de-

TABLE 5

IMPLICATIONS OF IMF PROJECTIONS FOR LDC CAPITAL TRANSFERS TO THE WEST–1986

($ Billions and Percentages)

	1982	1983	1984	1985	1986	1987	1989	1991
Western Hemisphere (1)								
Total Debt ($B)	328.8	340.4	351.4	373.1	383.3	390.7	409.9	429.7
Debt Ratio (2)	267.2	287.5	273.3	295.0	311.1	296.0	263.5	234.4
Debt Service ($B)	61.0	50.9	54.5	55.8	53.6	52.4	70.9	68.6
Debt Service Ratio (2)	49.6	43.0	42.4	44.1	43.5	39.7	45.6	37.4
Interest Payment ($B)	39.3	36.3	38.3	37.3	34.3	33.5	37.0	38.5
Interest Paymt. Ratio (2)	31.9	30.7	29.8	29.5	27.8	25.4	23.8	21.0
Net New Borrowing ($B)	41.8	11.6	11.0	21.7	10.2	7.4	19.2	19.8
Transfer ($B) (3)	2.5	-24.8	-27.3	-15.6	-24.0	-26.1	-17.9	-18.7
Transfer Ratio (2)	2.1	-20.9	-21.2	-12.3	-19.5	-19.8	-11.5	-10.2
Countries With Recent Debt-Servicing Problems (4)								
Total Debt ($B)	488.6	509.5	526.0	556.7	567.0	584.4	601.1	627.8
Debt Ratio (2)	234.5	252.3	244.2	260.6	275.4	261.0	232.7	206.4
Debt Service ($B)	79.6	69.5	75.6	78.8	77.6	77.9	98.4	97.0
Debt Service Ratio (2)	38.2	34.4	35.1	36.9	37.7	34.8	38.1	31.9
Interest Payment ($B)	48.5	45.2	48.7	49.1	47.4	47.0	49.9	51.4
Interest Paymt. Ratio (2)	23.3	22.4	22.6	23.0	23.0	21.0	19.3	16.9
Net New Borrowing ($B)	62.4	20.9	16.4	30.8	10.3	17.4	16.7	26.7
Transfer ($B) (3)	13.9	-24.3	-32.3	-18.4	-37.1	-29.6	-33.1	-24.7
Transfer Ratio (2)	6.7	-12.0	-15.0	-8.6	-18.0	-13.2	-12.8	-8.1
Fifteen Heavily Indebted Countries (5)								
Total Debt ($B)	377.0	391.2	404.0	416.3	427.9	441.1	448.6	433.4
Debt Ratio (2)	263.4	286.3	268.1	285.9	304.8	285.4	249.2	216.7
Debt Service ($B)	68.6	580.7	62.7	63.8	64.0	63.5	80.1	73.4
Debt Service Ratio (2)	47.9	425.0	41.6	43.8	45.6	41.1	44.5	36.7
Interest Payment ($B)	43.2	40.3	43.4	41.6	39.6	38.9	41.2	39.4
Interest Paymt. Ratio (2)	30.2	29.5	28.8	28.6	28.2	25.2	22.9	19.7
Net New Borrowing ($B)	48.7	14.1	12.8	12.2	11.6	13.2	7.5	-15.2
Transfer ($B) (3)	5.5	-26.2	-30.6	-29.4	-28.0	-25.8	-33.7	-54.6
Transfer Ratio (2)	3.8	-19.1	-20.3	-20.2	-19.9	-16.7	-18.7	-27.3

(1) See footnote (3), Table 4.
(2) Total debt, debt service, interest payments and transfer as a percent of exports of goods and services.
(3) Interest payments minus net new borrowing. A minus sign indicates an outflow of capital from the indebted nations to their creditors.
(4) See footnote (4), Table 4.
(5) See footnote (5), Table 4.

Source: Author's calculations derived from IMF, *World Economic Outlook*, Washington, D.C., April, 1986, Tables A54, A55. This table is an updated and expanded version of a table which appears in Harold Lever and Christopher Huhne, *Debt and Danger: The World Financial Crisis*, Boston: The Atlantic Monthly Press, 1986, page 66, Table 4.

TABLE 6

CURRENT ACCOUNT BALANCES AS A PERCENT OF EXPORTS OF GOODS AND SERVICES

(Percent)

	1968–77	1978–85	1986–91
Capital Importing LDCs (1)	-11.0	-12.0	-6.1
Western Hemisphere (2)	-18.0	-18.9	-4.5
Countries with Recent Debt Servicing Problems (3)	-14.0	-16.5	-4.4
Fifteen Heavily Indebted Countries (4)	-14.7	-17.8	-2.5

(1) See footnote (2), Table 4.
(2) See footnote (3), Table 4.
(3) See footnote (4), Table 4.
(4) See footnote (5), Table 4.

Source: International Monetary Fund, *World Economic Outlook, 1986*, Tables A35 and A54.

mand for U.S. exports. Moreover, even if all of the assumptions underlying the IMF's projections prove to be correct, real GDP growth in the capital importing countries is projected to average 4.7 percent in 1988–91 compared to 5.7 percent in 1968–72.

The IMF, in analyzing future prospects for these nations, notes that the indebted nations are "vulnerable to external factors, especially to a slowdown of growth in the industrial countries." And it admits that "for the highly indebted groups...there is little or no margin for downside developments: any substantial external setback will result either in a decline in the already very moderate growth projected under baseline assumptions, or in a

reversal of improvements in the external debt situation, or in some combination of the two."

Is Default Likely?

Thus we see that even under relatively optimistic assumptions, the indebted LDCs, and particularly the fifteen largest debtors (which include all major Latin American economies), cannot anticipate either a resolution of their current problems or any very substantial improvement. All along, however, their governments have imposed economic measures which have significantly reduced living standards. Is it reasonable to expect that politicians will continue to demand these sacrifices of their people when there is no end in sight? Clearly, if they did, it is unlikely that they would remain in power. Harold Lever and Christopher Huhne, in their recent book, *Debt and Danger,* make the obvious point that "If pushed to make a choice between servicing the banks' debt and serving their people, few, if any, of Latin America's leaders are likely to fail to serve their people." And, they conclude, "Default cannot be ruled out on either economic or political grounds."

Moreover, the conventional arguments against default do not stand up well to scrutiny. One of the major reasons for avoiding default is the prospect of a loss of future credit. However, if, as shown, IMF projections do not imply a resumption of net positive capital flows to the indebted LDCs even if they continue to service their debt and take the necessary policy steps to correct the present imbalances, what do they have to lose by defaulting? Obviously, they could only gain under present circumstances since the funds that are now going to service the debt, which represent a significant proportion of the product of their economies, could be used to promote domestic growth.

An important reason for not defaulting is the fact that trade credits would also dry up. This means that the defaulting nation would have to conduct all its trade on a cash or barter basis. To do so it would need to have enough reserves to meet the gap between export receipts and import payments (approximately six months of imports). Not surprisingly, the indebted LDCs have been increasing the ratio of reserves to imports of goods and services. And barter trade has also been rising.

In 1984, Brookings Institution economists Thomas Enders and Robert Mattione estimated the impact of default on Brazil, Argentina, Venezuela and Mexico and found that it would result in net gains for all four countries if the cost of repudiating the debt is 5 percent (that is, import costs rise by 5 percent and export receipts fall by 5 percent). Moreover, they found that if the cost of repudiation were 10 percent, Brazil, Argentina and Venezuela would still enjoy net economic gains.

Another reason why default would be to these nations' disadvantage is the threat that the assets held abroad would be seized to satisfy creditors' claims. However, most of these are private assets of individuals and corporations. It is unlikely that an American court would freeze the assets of private individuals to satisfy claims on the defaulting State. The only State assets of importance are foreign exchange reserves held at the Federal Reserve Bank of New York. But these funds have a certain measure of immunity. It is unlikely that the New York Fed would risk the liquidity crunch which would occur if the indebted LDCs felt that their reserve funds were not safe in deposit in New York. Moreover, if that were a real threat, the funds could be quickly and quietly moved to the safety of the Bank for International Settlements in Switzerland.

Nonetheless, and despite the potential gains, the Latin American debtors have gone to great lengths to repay the debt and disassociate themselves from the calls for default by Fidel Castro (who despite the rhetoric has continued to meet the payments on Cuba's foreign debt), or the limits placed on debt repayments by Alan Garcia, the President of Peru. They have also resisted the pressures for forming a debtors' cartel despite the increased leverage this might give them in bargaining with the creditor banks. But given the debt prospects outlined above, it is not out of the question to foresee a process of gradual unilateral limits on debt repayment, particularly in light of the political and economic pressures that the governments of the indebted nations are facing.

The Impact of Default

In mid-1984, Data Resources, Inc. performed a study of the likely impact on the U.S. economy of a two year moratorium on interest payments on the debt of the four major Latin American debtors (Argentina, Brazil, Mexico and Venezuela). The study, which assumed that the Federal Reserve would intervene to mitigate the domestic impact of such an action (a crucial assumption), found that real GNP would, nevertheless, decline and unemployment would rise as U.S. interest rates increased.

In 1982, in testimony before the House Banking Committee, then-Secretary of the Treasury Donald T. Regan outlined the channels through which the U.S. economy would be affected if the loans to the indebted nations had to be written off. There would a credibility-shattering loss of income to the banks whose capital/assets ratios would decline. The banks would, in turn, have to reduce overall lending, including lending to domestic individual and corporate borrowers. As the supply of loanable funds falls, interest rates rise. Higher interest rates would have a negative impact on all sectors of the domestic economy, including residential and nonresidential investment and purchases of consumer durables. As production in these

sectors falls, unemployment would rise and personal income would fall.

This scenario is not an extreme alternative considering that as of last March, the nine largest U.S. banks had loans outstanding to the ten major Latin American debtors equal to 71 percent of their total capital. Some, of course, are exposed more than others. According to Lever and Huhne, at the end of 1984, the exposure of one major U.S. bank to Mexico, Brazil, Argentina and Venezuela amounted to 173 percent of that bank's capital. And, other major U.S. banks are similarly exposed.

The problem is not confined to the United States. Of the four major British banks, two, Lloyds and Midland, have exposures of 165 percent and 205 percent of capital, respectively, to these same four countries. The international exposure of the non-American banks carries with it an additional problem, namely, that foreign banks' international loans are denominated in dollars, while their capital is in their national currencies. Thus, their foreign lending has been financed through dollar deposits. If concerns over possible LDC defaults were to lead to withdrawals of these dollar deposits, the banks would be unable to satisfy the demands upon them. According to Lever and Huhne, "the foreign currency deposits of the British banks–overwhelmingly in dollars–exceed the foreign currency reserves of the Bank of England by a factor of 35."

Proposed Solutions

As the foregoing has shown, the problems facing the heavily indebted nations, particularly those in Latin America, have not only caused widespread misery in those countries, but also affected U.S. production and jobs. Until recently, the debt problem was managed as if it were a liquidity crisis. Last October, recognizing that what we are dealing with in many of these countries is insolvency, Secretary of the Treasury James Baker put forward an important new initiative. Since then, several other proposals have surfaced, including one introduced in late July by Senator Bradley (D-NJ). This section details some of the advantages and disadvantages of several of the proposals to deal with the crisis.

A key requisite to the long-term solution of the debt crisis is the enactment of market-oriented policies in the debtor nations geared toward correcting the mistakes of the past. External factors (i.e., the 1979 oil price shock, the 1982 recession, high interest rates, and low commodity prices), only precipitated the crisis. The root cause of the current problem lies in decades of unremitting experimentation with socialism, central planning, state capitalism and government intervention in the economy; policies which have contributed to the impoverishment of millions of individuals and have squandered the vast resources of the continent. In contrast, the historical record demonstrates that those nations that followed free market development strategies have experienced rapid advances in their standards of living. Indeed, there are many developing countries (most of them in Asia) whose debt burdens are as high as those of the problem debtors but who, nevertheless, have been able to continue growing and servicing their debt. (For a discussions of the causes of the debt crisis, see the September, 1985 issue of *Economic Outlook*.)

The problem debtors face a major policy challenge which they have yet to fully recognize. This is true even in the case of Brazil, whose economy appears to have improved markedly since adjustment began. The problem debtors need to institute supply-side measures to improve private sector incentives. Such measures include: First, the reduction of fiscal sector deficits through reductions in government spending, not further increases in taxes. Major reductions in government involvement in the domestic economy would go a long way toward reducing the fiscal deficit. The economies of all the problem debtors are burdened by inefficient state enterprises which provide low quality service and operate at a loss, making government subsidies necessary to their continued operation. There is a direct relationship between the operating deficits of these state enterprises and foreign borrowing.

Second, it is imperative that fiscal deficits not be financed through the printing of domestic currency, a factor which has been a major contributor to rising inflation. Third, price controls should be dismantled to eliminate shortages and allow the market to function. The Brazilian government's Cruzado Plan (a price freeze), has been applauded for the impact it has had in reducing inflation. However, the price controls have resulted in shortages of many commodities. In a bizarre twist of events, the government is now subsidizing milk producers in an effort to counteract the shortages of milk which resulted from price controls.

Other measures which would improve the long range economic potential of the indebted nations are:

The elimination of exchange and trade controls and excessively high tariffs which distort domestic production by protecting inefficient domestic industries.

Realistic exchange rates to improve the international competitiveness of exports. The decontrol of credit markets to maintain appropriate interest rates that will stimulate domestic savings and prevent capital flight.

The establishment of producer prices, particularly for agricultural commodities, which reflect world market prices so as to increase incentives for domestic production.

The elimination of price subsidies to consumers.

The removal of restrictions on private foreign investment which could increase capital investment without implying increased debt.

The enhancement of private property rights.

No other economic indicator better reflects the inadequacy of the economic policies in the Latin American LDCs than the pervasiveness of capital flight. In many cases, if these funds could be repatriated a large proportion of the debt problem would be alleviated. Capital flight is not the fault of unpatriotic individuals but of government policies which discourage private investment in the domestic economy.

All of these policy recommendations are geared toward opening up the economies of the debtor nations. They reflect the acceptance of the fact that import substitution as a development strategy has failed, and recognize that those nations which based their development strategies on export-led growth are today thriving, in sharp contrast to the results obtained in Latin America. But, for such a strategy to succeed, the industrial countries must also do their part and recognize that in order for the indebted LDCs to be able to repay their debts they must be able to increase exports and increase their foreign exchange earnings. This cannot be accomplished if their access to industrial country markets is restricted. Thus, industrial countries must refrain from increasing barriers to exports from the LDCs and must work actively to defuse the protectionist bomb. For instance, the U.S. sale of subsidized wheat and beef has seriously affected the exports of some major debtors, most notably Argentina and Uruguay. In this regard, it should be noted that Argentina has threatened to reduce its repayments of debt to U.S. banks in proportion to the damage to its export trade resulting from U.S. dumping of wheat in international markets.

In addition, the industrial country governments should also extend new credits to the indebted LDCs. An effective way of doing this is through official export credit agencies whose activities could be coordinated with those of the commercial banks and the multilateral lending institutions. Finally, it must be recognized that the commercial banks operate within a regulated environment and that they must heed the rules set down by bank regulators. The relaxation of some of these rules would make it easier for the commercial banks to continue lending to the indebted LDCs. For instance, in the United States, bank regulators have allowed banks with a large percentage of energy and agriculture loans to reduce their capital/assets ratio below the required six percent.

But these reforms may take time to institute. Recognizing this, the Baker Plan attempts to deal with the immediate problems—severe recession and continued debt servicing problems—facing the major debtors. This proposal entails an increase in lending, both from commercial banks and multilateral institutions in return for commitments from the major debtors that they will enact the appropriate market-oriented policies enumerated above. The proposal also implies a greater role for the World Bank in directing the flow of resources to the developing nations, while the commercial banks are expected to significantly reduce the fees and commissions they charge for rescheduling due debts and reduce the interest rate mark-up on loans to problem debtors.

Although the creditor banks initially voiced their support for the Baker Plan, commercial bank lending has not increased. And while World Bank commitments have risen, disbursements have not increased significantly. With the exception of Ecuador, whose debts are tiny compared to those of Mexico, for instance, the Baker Plan has had no real successes since it was introduced almost a year ago. After stalling to the point that the negotiations were in danger of becoming unravelled, negotiators for Mexico, the multilateral institutions and the creditor banks reached an eleventh-hour agreement on a $12 billion rescue package. Everyone seemed to come out ahead from the negotiations: While the banks fended off Mexico's efforts to tie the debt to the price of oil, they did agree to provide a contingency fund which can be used if the Mexican economy does not achieve rates of growth in the three to four percent range (an implicit link to oil market developments). Mexico also got the banks to lower interest charges to 0.8 percentage points above the London interbank offered rate (LIBOR), a slight (0.3 percentage point) decline from the rate the banks were demanding initially, but one which, nonetheless, signifies a savings of $136 million in interest charges. And the World Bank has agreed to guarantee a small proportion of the loan—$500 million—an amount small enough to avoid charges that the Bank is "bailing out" the commercial banks. Everyone has saved face. Unfortunately, the real test of the success of the Baker initiative is not whether or not an agreement is reached but whether or not the Mexican economy can resume growing.

Mexico blames its current problems on the decline in world oil prices and the depressing impact this has had on the country's export earnings. However, Ecuador and Venezuela face the same problem but are not in such dire straits. Ecuador is the only success story in Latin America. Faced with a $1 billion shortfall in oil revenues, the Ecuadorian government responded by devaluing the currency and establishing a free-market growth strategy. As a result, the country is obtaining a $220 million loan arranged by Banque Paribas. The loan is $20 million over the amount originally requested because it was oversubscribed. According to *The Economist*, "This is the first time that a Latin American debtor which has gone through an IMF-sponsored restructuring has voluntarily been offered new commercial bank money." Venezuela,

on the other hand, whose government has yet to reform most of its interventionist policies has not been so "lucky."

Arguing that the IMF loans have only served to finance debt payments, not rekindle economic growth in Latin America, Senator Bradley has proposed an innovative scheme which recognizes that U.S. trade performance is tied to the debt crisis. His plan includes the annual convening of a trade/debt summit conference with participation by the representatives of the banks and the governments of all the major creditor nations as well as the indebted nations. At these conferences, creditors would offer debt and interest rate relief in exchange for debtor reforms designed to restore balance to trade, increase economic growth and strengthen the international financial system. Specifically, if debtors liberalize trade, enact policies which would reverse capital flight, encourage domestic investment, and promote domestic economic growth, then the creditors would (1) reduce interest rates by three percentage points, (2) write down and forgive three percent of the principal on outstanding commercial and bilateral loans, and (3) provide new multilateral project and structural adjustment loans amounting to $3 billion a year.

One of the arguments against the Bradley proposal is its impact on the commercial banks. The commercial banks should continue to be concerned about the likelihood of *de facto* default. Clearly, this alternative is much more dangerous than a gradual writing-down of debt. Moreover, the secondary market for Latin American debt is not emitting healthy signals. Table 7 shows that bank loans to Venezuela are being offered for sale at 77 cents to the dollar. At the other extreme, Peruvian debt is being offered at only 24 cents to the dollar, and Bolivian debt at eight cents. The commercial banks, however, are continuing to carry the debt on their books at 100 percent of face value. These discounts at which the debt is being offered are an indication of the riskiness of the loans.

TABLE 7
FOREIGN DEBT PRICES
(Cents per Dollar of Book Value)

Country	Offer Price
Argentina	67
Bolivia	8
Brazil	76
Chile	69
Ecuador	66
Mexico	62
Peru	24
Venezuela	77

Source: The Wall Street Journal, Tuesday, October 7, 1986.

To their credit, the commercial banks have, in some cases, reduced the interest rate mark-up. In addition to Mexico, restructuring of the Chilean debt was concluded at 1.625 percentage points above the LIBOR and the interest rate charged on the debt of the Dominican Republic and Uruguay is now 1.375 percentage points above the LIBOR. Moreover, in all of these cases and others as well, the commercial banks have allowed grace periods during which only the interest payments on the debt are due. Nevertheless, a gradual writing down of these loans seems to be called for, and, in fact, several European banks have already done so.

Another argument against the Bradley Plan is the fact that writing-off of debt will damage the credit ratings of the indebted countries for years to come. But, under current projections, the Latin American debtors are unlikely to receive enough new loans to cover interest payments. In addition, recent default experience shows that future credit will not dry up. In the 1930s, all of Latin America wrote down its debts, serviced them in local currency or simply failed to pay. According to Professor Dornbusch, in 1949 "...of the whole of Latin America's debt, half was in complete default, 45 percent was serviced with write-downs of principal and interest, and less than 3 percent was serviced on the original contracts of the principal outstanding. And Latin America prospered."

It has also been argued that the relief proposed by Senator Bradley is unnecessary because economic conditions have lately improved in many of these countries. This assertion ignores the fact that long-term progress will not be possible unless the Latin countries drastically reform their policies to allow the free market to work. It is true, for instance, that the Brazilian economy has recovered: real GDP growth exceeded 8 percent last year and industrial production rose by 12 percent. But the policies that have achieved these results are woefully inadequate and pose long-term threats to the economy.

For instance, inflation has been repressed through price controls but all indications seem to be that prices will surge once the controls are removed. The freeze has translated into shortages and price increases disguised as quality and quantity improvements. The budget deficit is now 5.4 percent of GNP, significantly higher than the 0.5 percent initially projected. And, monetary growth figures show that the deficit is being monetized. Moreover, the government has found a novel way of increasing taxes by imposing surcharges—euphemistically called "loans"—on the purchase of new and used cars, gasoline, airline tickets, and central bank sales of dollars for foreign travel. The proceeds from these "loans" go into the newly created National Development Fund which is to carry out social and infrastructure investment. These are hardly the types of policies which will enhance the operation of market mechanisms, increase economic incentives and efficiency, and reduce the level of government intrusion in the economy.

The most important issue, which the Bradley Plan ad-

dresses and the Baker Plan does not, is the fact that the negative transfer of funds from the indebted countries to their creditors in the West must come to an end if the economies of the debtor countries are to resume growing. In this regard, the World Bank staff, in an internal memorandum, has suggested that the Baker Plan could be improved by (1) extending it to six years for countries which meet certain criteria; (2) the World Bank should make concessions in the repayment schedules of certain debtors so as to assure a substantial positive net transfer of funds; and, (3) that commercial banks refrain from charging rescheduling and refinancing fees and reduce the interest rate they charge to the London interbank offered rate.

A third proposal attempts to deal with the problem of the existing debt on banks' books by making government guarantees available on condition that the banks would, each year, write down a portion of the existing debt. The government guarantees would, in effect, be a sort of insurance similar to that already provided by the Export-Import Bank, allowing the banks a longer period of time during which to write down the riskiest loans. Finally, a new issue of IMF Special Drawing Rights, which would be tantamount to increasing the world supply of money, could also be considered. But, since these issues are usually in proportion to a country's IMF quota, that is, its economic weight within the system, this might not significantly increase the funds available to the LDCs. However, if as has been proposed, the new issue were made available to the IMF itself, it would represent an increase in its resources which it could then disburse to countries undergoing adjustment programs.

Conclusion

The purpose of this article is to emphasize the need for cooperation in resolving the debt crisis. The commercial banks and the industrial country governments should assist the indebted nations in enacting the policies that will bring about a renewal of economic growth. If economic growth does not resume, the people of Latin America are likely to lose their patience with governments that have presided over years of economic austerity. If this happens, they are likely to bring into power a government that promises to repudiate the debt and concentrate on restoring growth and employment. Even if there are no changes in the governments themselves, political pressures would change the stance of those who are now continuing to negotiate. The recent agreement between Mexico and the banks shows that this is already happening. After its conclusion, Mexico's chief debt negotiator said in a speech that while his country wants to work within the system, "If cornered, [the] government has to put the interest of [its] people first." And, to the consternation of the bankers, he added, in response to a question about the relationship between interest payments and the political situation in Mexico, that "Now [paying interest] is an option; before, it was a fact." The specter of debt repudiation is real. The financial community cannot afford to ignore it.

The long term resolution of the debt crisis involves four key elements: (1) the resumption of positive net lending to the LDCs; (2) major policy shifts which will give greater play to market forces in the debtor nations and lay the foundation for sound economic growth; (3) continued growth in the industrial countries to assure that the debtor nations can earn the needed foreign exchange through export growth; and, (4) allowing the commercial banks sufficient time to write down the debt without it having a major impact on their capital/assets ratios. It is a long-term proposition which requires the collaboration of all the parties involved.

As the experience of Ecuador shows, market-oriented policies in the debtor nations will work (and they may work faster than is generally assumed). In addition, commercial banks have shown themselves willing to increase lending voluntarily once positive results are achieved, as the case of Ecuador also shows. However, interventionist government policies are so entrenched in many of the largest problem debtors that they cannot be immediately reversed without resulting in rising unemployment and running the risk of political upheavals. In such cases, it is imperative that the debtor governments be encouraged to take these steps. The best form of encouragement is the promise of a resumption in net positive transfers of funds, not the threat of poor credit ratings. The commercial banks must realize that they will be better able to ensure the repayment of interest and principal on these loans if the debtor countries are growing than if they are forced to continue enforcing austerity measures.

The commercial banks would be more willing to renegotiate LDC loans at lower interest rates (as both the Baker and the Bradley plan suggest), if the bank regulators were to ease some of the applicable rules. At the moment, however, the banks are penalized for lending new money. The U.S. Comptroller of the Currency has told the creditor banks that existing loans as well as new loans extended to several of the problem debtors should be treated as problem loans. This requirement is directly opposed to the notion prevailing both at Treasury and at the Fed, that under some circumstances, new lending can help improve the quality of the loans. The problem with regulations governing commercial bank lending to the LDCs is not peculiar to the United States. Bank officials in Canada, Japan and some European nations have required banks to increase their reserves against loans to several debtor countries. These requirements are another hurdle in the road to a resolution of the debt crisis.

It is time for the American business community to become involved in the debt debate so as to assure that a coherent set of positive policies emerges from all the solutions that have been proposed so far.

TRENDS IN COMMERCE
NOTES ON TABLE II
OCTOBER/NOVEMBER 1986

by
*Martin Lefkowitz**

Gross National Product (GNP) – The revised estimate of Gross National Product – the total value of goods and services produced in the economy – shows that second quarter GNP grew at a 0.6 percent annual rate. Final sales, after adjusting for inflation, grew at a vibrant 3.4 percent rate in the second quarter in contrast to a 1.3 percent decline in the first quarter, but the lower pace of inventory build-up, which had added $45 billion to first quarter GNP, subtracted $24 billion from second quarter output. Consumer spending remained strong, growing at a 6.2 percent rate in the second quarter. Despite a 2.3 percent drop in nonresidential fixed investment, producers' durable equipment purchases rose at an annual rate of 19.6 percent. The second quarter data continued to reflect a sharp deterioration in the nation's trade deficit, with exports declining by 9.4 percent while imports rose by 18.5 percent.

The Services Sector – Employment in service sector establishments increased by 150,000 jobs in September and is now 2.2 million jobs above its year-ago level. This compares with no change in jobs in the goods-producing sector over the last twelve months. Over the past year, the manufacturing sector has lost 114,000 workers. All of the job growth in the economy during the past year has been in services industries.

Consumer purchases of services increased by 0.2 percent in August. Major domestic airlines reported that revenue passenger miles flown, that is, the number of passengers multiplied by the miles flown by each passenger, reached 27.1 billion in August, an increase of 18 percent from its year-ago level, and the best traffic month in the history of the industry. Over the past eight months, domestic passenger travel has increased by 11.7 percent and available seat miles were up 11.7 percent. International passenger traffic experienced a 0.6 percent decline in August compared to August of last year.

Money Supply – The nation's money supply – as measured by M1, currency in circulation plus demand deposits – increased by 1.7 percent in August and was 13.7 percent above its year-ago level. In the six months ended in August, M1 was up at an annual rate of 13.7 percent. This is considerably above the Fed's target range of three to eight percent.

Employment – The civilian unemployment rate inched back up to 7.0 percent in September from 6.8 percent in August, after declining for three consecutive months. Employment in service producing industries grew by 150,000 jobs in September, with much of the gain concentrated in business and health services, retail trade, finance, insurance and real estate. In September, civilian employment slipped back slightly to 109.9 civilian job holders. The U.S. economy first passed the 100 million job mark in 1981 and has created more than 10 million new jobs in a little over five years.

Consumer Price Index – The Consumer Price Index for all urban consumers (CPI-U) increased by 0.2 percent in August, following no change in July. Energy prices continued to be the largest moderating force while food prices and apparel costs accelerated. The index for food and beverage prices posted its largest increase in over two years, rising by 0.9 percent in August. Gasoline prices were down 4.7 percent in August and have dropped over 30 percent in the first eight months of 1986.

The Producer Price Index for finished goods increased by 0.4 percent in September after rising 0.3 percent in August. The September increase was, in large part, the result of a 3.7 percent increase in energy prices while food prices fell by 0.2 percent. During the last 12 months, finished goods prices at the wholesale level have declined 0.7 percent. The intermediate goods index rose by 0.5 percent, the first significant increase registered this year. Although energy prices led the upturn, there were large advances among metals and construction materials. However, the index for intermediate goods excluding energy and food edged up 0.3 percent. After falling 0.2 percent in August, the crude goods index rose 0.5 percent in September. Crude food prices declined 0.8 percent in September following a 2.5 percent increase in August and prices other than food and energy increased 0.5 percent.

Housing Starts – Privately owned housing units were started at a seasonally adjusted annual rate of 1,822,000 units in August, virtually unchanged from the July level. August housing starts were 5 percent above the August 1985 level. The data reflected a continued decline in apartment construction which many are attributing to tax reform legislation, while single-family home construction was up 3 percent. The Midwest reported the largest decrease in new home starts while the Northeast had an 18 percent increase for the month. Building permits, an indicator of future activity in the home building industry, were down 7 percent for the month.

Corporate Profits and Cash Flow – Corporate profits have been sluggish for the past year. While profits in-

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TABLE II
TRENDS IN COMMERCE

	Current Period		Previous Period	Year Ago	Percent Change From Previous Period	Percent Change From Year Ago
Population (Millions) [a]	Aug 86	241.8	241.6	239.2	0.0	1.0
Gross National Product ($B)	II 86	4,175.6	4,149.2	3,965.0	0.6	5.3
Gross National Product (82$B)	II 86	3,661.4	3,665.9	3,567.6	0.1	2.6
Money Supply (M1) ($B)	Aug 86	687.8	676.1	604.8	1.7	13.7
PEOPLE AND THEIR MONEY						
Personal Consumption Expenditures ($B)	Aug 86	2,797.1	2,765.8	2,626.9	1.1	6.5
Personal Consumption Expenditures (82$B)	Jul 86	2,427.2	2,418.9	2,316.5	0.3	4.8
Disposable Personal Income ($B)	Aug 86	2,986.9	2,979.4	2,828.6	0.2	5.5
Disposable Personal Income (82$)	Jul 86	2,614.7	2,610.5	2,528.2	0.1	3.4
Personal Savings Rate (%)	Aug 86	3.1	4.0	4.1	−0.9[b]	−1.0[b]
Civilian Employment (millions)	Sep 86	109.9	110.2	107.8	−0.2[c]	1.9[c]
Civilian Unemployment Rate (%)	Sep 86	7.0	6.8	7.1	0.2[b]	−0.1[b]
Average Hourly Earnings	Sep 86	$8.81	$8.69	$8.67	1.4	1.6
Consumer Price Index (All Urban, 67 = 100) [a]	Aug 86	328.6	328.0	322.8	0.2	1.8
Purchasing Power of the Dollar (67 = $1.00) [a]	Jun 86	0.304	0.305	0.313	−0.3	−1.6
Prime Interest Rate (%) October 1, 1986		7.5	8.5	9.5	−0.5[b]	2.0[b]
Retail Sales ($B)	Aug 86	120.2	119.2	116.2	0.8	3.4
SERVICES SECTOR						
Employment in Services (Millions)	Sep 86	75.5	75.4	73.3	0.1	3.0
Consumer Purchases of Service ($B)	Aug 86	1,454.7	1,452.3	1,346.1	0.2	8.1
Consumer Purchases of Service (82$B)	Jul 86	1,185.8	1,180.1	1,141.3	0.5	3.9
Domestic Revenue Passenger Mileage Flown						
Major Airlines (Billions) [a]	Aug 86	27.1	25.7	23.0	5.4	18.0
BUSINESS PROFITS AND OUTPUT						
Corporate Profits and Cash Flow ($B)						
Before Tax	II 86	231.3	224.3	213.8	3.1	8.1
Profits Tax Liability	II 86	93.3	89.1	87.1	4.7	7.1
Tax Liability as a Percent of Profits	II 86	40.3	39.7	40.7	1.5[b]	−1.0[b]
After Tax	II 86	138.0	135.2	126.7	2.0	8.9
Net Cash Flow	II 86	380.6	380.9	370.8	−0.0	2.6
Industrial Production (77 = 100)	Aug 86	124.8	124.6	124.3	0.1	0.3
Capacity Utilization Rate (Mfg.) (%)	Aug 86	79.6	79.5	80.3	0.1[b]	−0.6
New Housing Starts (thou. units)	Aug 86	1,822.0	1,815.0	1,737.0	0.3	4.8
BUSINESS COSTS						
Unit Labor Costs (nonfarm) (77 = 100)	II 86	169.1	168.8	165.9	0.1	1.4
Unit Nonlabor Costs (nonfarm) (77 = 100)	II 86	164.8	163.9	160.8	0.5	2.5
Producer Price Indices (67 = 100) [d]						
Crude Materials	Sep 86	275.5	275.5	291.8	0.5	0.4
Intermediate Goods	Sep 86	306.1	304.5	317.7	0.5	0.5
Finished Goods	Sep 86	286.6	287.2	290.0	0.4	0.5
FEDERAL SPENDING AND DEBT						
Federal Spending Index (67 = 100)	Aug 86	637.2	638.5	629.8	−0.2	1.2
Federal Gov't Gross Debt Outstanding ($B) [a]	May 86	2,035.6	2,012.6	1,758.3	1.1	15.8
INTERNATIONAL TRADE						
Exports of Goods & Services ($B)	II 86	363.0	374.8	370.0	−3.1	−1.9
Imports of Goods & Services ($B)	II 86	467.5	468.5	447.1	−0.2	4.6
Balance on Goods & Services ($B)	II 86	−104.5	−93.7	77.1	11.5	35.5
WHAT'S AHEAD?						
Index of Leading Indicators (67 = 100) [a]	Aug 86	179.1	179.5	169.2	−0.2	5.8

NOTE: All data seasonally adjusted unless otherwise noted

[a] Not seasonally adjusted
[b] Percentage point difference
[c] January data is a new series that is not comparable to previous data
[d] Index number not seasonally adjusted, percent change seasonally adjusted

creased by 8.1 percent between the second quarter of 1985 and the second quarter of 1986, they remained below the level of the fourth quarter of 1985. Economic profits, which take into account economic depreciation and adjust for changes in inventory valuation, were up 6.9 percent from their year-ago level. Net corporate cash flow, which includes depreciation allowances, increased nearly 2.6 percent from their year-ago level.

Industrial Production—Industrial production increased by 0.1 percent in August, following a revised 0.1 percent decline in July. Production in August was 0.3 percent higher than its year-ago level, but has declined by 1.1 percent since January. The August increase occurred in defense, construction supplies, nondurable consumer goods and nondurable materials. However, industrial production declined in the auto, steel, and electricity industries.

The August capacity utilization data shows that the nation's productive capacity has risen by an annual rate of 2.1 percent so far this year. The capacity utilization rate in manufacturing increased 0.1 percentage point, to 79.6 percent in August. The increase in the utilization rate occurred in the nondurable goods sector, while the durable goods sector experienced a decline. Between the second quarter of 1985 and the second quarter of 1986, durable goods capacity expanded by 2.6 percent and nondurable goods capacity increased by 1.3 percent.

Productivity—Nonfarm business productivity increased at a seasonally adjusted annual rate of 1.6 percent in the second quarter of 1986. This was about half the 3.3 percent growth rate reported in first quarter. Output rose by 1.3 percent while hours worked declined 0.3 percent. This was the first decline in hours worked since the fourth quarter of 1982 when they fell at a 3.4 percent rate. Manufacturing productivity rose at a 1.9 percent annual rate in the second quarter, and output declined by 1.5 percent, while hours dropped by 3.4 percent. This was the first quarterly decline in manufacturing output since the fourth quarter of 1982.

Interest Rates—The prime interest rate is currently 7.5 percent, 2.0 percentage points below its year-ago level. Three- and six-month Treasury bill rates were 5.2 and 5.4 percent, respectively, in early October. Thirty-year Treasury bonds, which traded at about 7.6 percent at the end of September, were up from 7.2 percent a month earlier.

Federal Spending—The "Federal Spending Index," a U.S. Chamber devised measure of the monthly change in federal expenditures, declined to 637.2 in August (1967 = 100), a 0.2 percent decrease from the previous month and 1.2 percent above the level of August 1985. Federal receipts for the first eleven months of fiscal year 1986 increased by 4.7 percent, while expenditures for the same period rose by 4.2 percent. The federal deficit for the first eleven months of fiscal year 1986 was $217 billion compared to $211 billion during the same period in fiscal year 1985.

Personal Savings—The personal savings rate was 3.1 percent of after-tax income in August, the lowest level since September 1985. Personal savings continue to remain at a relatively low rate from an historical perspective. However, business savings and the inflow of foreign capital appear to be making up for this anemic rate of savings by individuals.

Retail Sales—Retail sales rose by 0.8 percent in August, following a revised 0.3 percent increase in July. The August increase occurred despite the decline in gasoline sales which dropped by 1.8 percent due to lower prices, and food store sales which fell by 0.1 percent. The rise in retail activity was largely attributed to increased department store and auto sales.

Trade Deficit—On a goods and services basis, the trade deficit in the second quarter of 1986 was $104.5 billion, a significant jump from the $93.7 billion reported in the first quarter. The continued increase in the trade deficit occurred despite lower oil prices and a significant drop in the value of the dollar. The larger deficit was mainly the result of a decrease in exports. The U.S. merchandise trade deficit improved greatly in August shrinking by $4.7 billion. The decline in the deficit was due to an increase in agricultural exports and a significant decrease in imports of manufactured goods.

What's Ahead—The composite index of leading indicators, designed to predict future movements in aggregate economic activity, declined 0.2 percent in August, following a one percent increase in July. The indicator has now declined in three of the last four months, leading many economists to believe the economy is on a slow growth path. Six of the 11 indicators available for August were down and five were up. Major contributors to the August decrease in leading indicators include contracts and orders for plant and equipment, building permits, and change in sensitive materials prices. The positive contributors were changes in credit outstanding, stock prices, money supply, new orders for consumer goods and materials, and average workweek.

REAL EARNINGS

In five of the world's largest OECD economies, average hourly earnings in manufacturing are rising faster than consumer prices. The only exception was in Italy, where over the past year, earnings have increased by 5 percent compared with a rise of 5.9 percent in consumer prices. In England and West Germany, growth in earnings has exceeded inflation by 5 percentage points over the past 12 months; in the U.S. and Japan, the gap is much smaller, with real earnings in these two countries having risen by 0.8 and 3.8 percentage points respectively.

12/31/86 A 3840-6

ECONOMIC
OUTLOOK

Chamber of Commerce of the United States

December 1986/January 1987

THE MORALITY OF GOVERNMENT SPENDING

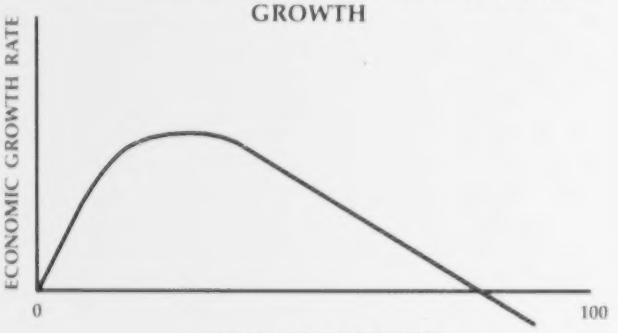
by
Richard W. Rahn

The warnings are already beginning to be heard: If government spending is reduced much further, we might precipitate a recession. In fact, some leading Democratic politicians are again muttering about the need to increase government spending to reduce poverty and unemployment. Such comments are not all that surprising, given that the last two generations have been taught that increased public spending can cure most of society's ills. This notion, echoed in the Catholic Bishops' recent pastoral letter on the U.S. economy, allows the advocates of bigger government to wear the moral mantle of superior compassion over their more fiscally conservative brethren.

Until now, calls for spending restraint have been predicated on a new and proper understanding that both high marginal tax rates and increased deficit financing reduce the economy's growth potential. However, the notion that government spending, in and of itself, may actually be destructive to economic prosperity has never been adequately challenged. In fact, only recently has the conventional wisdom begun to face some criticism. This is reflected in the fall from grace of Keynesian demand management policies, which argued that increased government spending would multiply itself through the economy to create higher levels of income. The same is happening in the area of development economics. Whereas in the past, the government was viewed as the initiator of economic development, there is today a growing realization that it was, in fact, central government planning in the development strategies of some LDCs, which has relegated many of these nations to perpetual misery.

But what if it were shown that increased government spending is destructive to greater prosperity? Then, the whole moral basis of the argument for increased government spending begins to shrivel away. In fact, the evidence is rapidly growing that beyond a certain point, increases in government spending (as a percentage of gross national product) becomes an economic hindrance; that is, additional spending is more likely to increase economic misery than to alleviate it. On the basis of this growing body of evidence and our observations of the effects of increases in government spending, we believe that the diagram in Figure 1 accurately represents the actual long-term effect of government spending on economic growth.

FIGURE 1
GOVERNMENT SPENDING AND ECONOMIC GROWTH



The first section of the graph shows that at zero or extremely low levels of government spending, economic growth is also low. Under conditions of anarchy, or the complete absence of a government sector, no progress can take place because public goods and services, essential for the proper functioning of markets, are not being provid-

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ed. Increases in government spending stimulate economic activity by providing those goods and services which facilitate market operation. A level of government spending sufficient to provide a judicial system encompassing basic protection of persons and property, adequate defense from foreign enemies, law and order, and fundamental "public goods" such as public health programs is necessary to provide the security required for people to work, save and invest. Sustained and rapid economic growth only takes place as a result of high levels of productive investment in both physical and human capital. Defense spending needs to be sufficiently high to give the majority of the citizenry the feeling of reasonable security about their own individual well-being and that of their property. U.S. defense spending, by providing a security umbrella for many of our allies and friends, encourages investment in many places outside the U.S., but in the long run, Americans also benefit from this increase in worldwide prosperity and security.

However, it is possible to reach a point where increases in the government's share of the economy no longer foster additional production and income. As the government sector begins to account for an ever larger share of total production, its positive contribution to aggregate economic activity begins to diminish. As it provides more and more goods and services, the public sector begins to compete directly with private sector providers. And since it also competes for the scarce resources available, the public sector effectively crowds out the private sector. Moreover, in many instances, public sector activities enjoy monopoly or quasi-monopoly powers not available to private suppliers. The end result, therefore, is that the economy's resources are inefficiently utilized and output gains are smaller.

At even higher levels of government spending, the public sector may actually have a negative impact on the economy by providing perverse incentives. For instance, many well-meaning social programs, largely those associated with income transfers and cash assistance, have such adverse effects on savings and labor supply that they discourage productive activity. Thus, their expansion would reduce, not increase, long run economic growth. Moreover, as the scale of government increases, it becomes increasingly necessary to raise taxes to pay for that ever-expanding supply of publicly produced goods. The negative effects of high taxes are, by now, a well established fact. Thus, the combination of high levels of government spending and the associated high tax burdens necessary to finance that spending are a powerful disincentive to productive economic activity.

Finally, in those few cases where there have been serious attempts at complete collectivization of the economy, such as Cuba in the early 1970s, or China during the "Great Leap Forward," the actual standard of living of the population declined for several years.

The diagram represents a greatly simplified statement of all of the economic forces at work. It is, of course, true that the point of diminishing GNP growth rates is not the same for all countries or consistent across all time periods. These variances do not, however, negate the validity of the general proposition.

Indeed, industrial country data for the past twenty years reflects this relationship. As Table 1 shows, average real GDP growth for the seven major industrial countries has declined steadily since 1965. Not coincidentally, the government share of GDP has risen just as steadily. This does not mean to imply that the increase in government spending is the only reason that economic growth declined, but we do believe it was a significant contributing factor. For instance, a recent cross sectional study of 30 countries by Barth, Keleher and Russek (July 1986) on the link between the size of government and economic growth shows a negative relationship in 27 cases, with 17 of those statistically significant.

TABLE 1

GOVERNMENT SPENDING AND GROWTH
SEVEN MAJOR OECD COUNTRIES
(Percent)

	Government Outlays as a % of GDP	GDP Growth Rate
1965–69	32.6%	5.0%
1970–74	33.4	3.6
1975–79	37.4	3.3
1980–84	41.2	1.8

Source: Organization for Economic Cooperation and Development

From the evidence, what can we conclude? First, a modest reduction in government spending will not cause a recession, but will enhance economic growth by reducing the government's claim on productive private economic activity. The exceptions to this would be if government programs which protect basic health and safety were reduced to an extent that the true economic costs suffered outweighed the spending reduction benefits, and if defense spending were reduced to put the country at risk.

Second, spending reduction can cause hardship to certain dependent citizens even though more citizens would be made better off because of the reduction. Hence,

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reasonable transitions or provisions in spending reduction programs are necessary to minimize undue hardship.

In sum, if a member of Congress is going to act as an economically responsible and moral individual, he or she must work to reduce aggregate government spending and to eliminate or modify those spending programs that cause more total misery than benefits.

THE SKY IS NOT FALLING

by
Graciela Testa-Ortiz

The American economy has entered its fifth year of uninterrupted growth. In fact, despite the worries of the Chicken Littles of the profession, the signals which usually presage recession are nowhere to be seen.

Historically, periods of economic expansion have ended when the economy reaches the limits of its productive capacity. The signals that presage the end of the expansion are rising interest rates, inflation, labor costs and capacity utilization rates. This time around, however, capacity utilization in the manufacturing sector remains substantially below the levels at which bottlenecks and supply interruptions would occur. Moreover, rather than increasing as the expansion progresses, as is usually the case, the rate of capacity utilization has been falling during the past two years. From the recession trough of 68.2 percent in the fourth quarter of 1982, it rose to a peak of 81.6 percent in the third quarter of 1984 and has been declining steadily since then, averaging 79.8 percent in the third quarter of this year.

Rising labor costs are another indication that the economy is facing constraints which can push it into recession. Unit labor costs have risen by only 3 percent since the second quarter of 1984. This has been an important factor in keeping inflation in check; the price level, as measured by the implicit GNP deflator, has increased by 13 percent since the end of the recession, compared to a 29 percent increase during the comparable period of the 1970s expansion. Measured on a year-ago basis, the rate of increase in the GNP deflator has been declining steadily since 1981. It is rising inflation during the later stages of recovery which prompts the monetary authorities to restrain the increases in the money supply, thus choking off the expansion.

Finally, during other expansions, as the economy continues to grow, the increased competition for loanable funds as well as rising inflationary expectations, put upward pressure on interest rates. Rising interest rates, in turn, depress activity in the interest-sensitive sectors such as housing and autos, and the decline in activity feeds through to the rest of the economy. This time around, however, not only have interest rates not risen, they have actually continued to decline. The three-month Treasury bill rate reached a peak of 10.3 percent during the third quarter of 1984 and has declined steadily since then, averaging 5.5 percent during the past quarter.

These developments notwithstanding, many analysts are calling for recession, or at least a slump, during the first half of 1987. According to these scenarios, the risk of recession arises from a combination of significant cutbacks in consumer spending and the effects of tax reform on the investment sector.

The mid-year surge in consumer spending, accompanied as it was by continued increases in the installment debt to income ratio and a sharp drop in the personal savings rate, have prompted many analysts to fear that the consumer is no longer in a position to continue supporting the expansion. These arguments are almost identical to those voiced at the end of 1985. During 1985, as is the case this year, consumer spending rose faster than the overall economy. In fact, the numbers are remarkably similar: real consumption increased by 3.5 percent in 1985 while gross national product rose by 2.7 percent; projections for 1986 place the consumer spending increase at 3.9 percent while GNP is anticipated to rise by 2.6 percent.

Then, as now, the increase in consumer spending was largely in durable goods consumption, and the bulk of that strength was accounted for by purchases of motor vehicles spurred by dealer incentives and below-market financing. Domestic car sales surged to 9.4 million units during the third quarter of last year; the story was repeated again this year as domestic car sales reached an annual rate of 9.7 million units during the third quarter, thanks to loan rates as low as 2 and 3 percent. Similarly, the ratio of consumer installment debt to disposable income was reaching new heights, and the savings rate had dipped substantially.

All of these developments are related. The below-market financing offered by auto dealers was a powerful incentive for consumers to buy new cars. As they did so, the savings rate declined and consumer installment credit outstanding surged. The personal savings rate fell by 2.5 percentage points between the second and third quarters of 1985 and then bounced back. The same pattern is being repeated this time around. The decline in the savings rate this year was of the same magnitude and, as of October, it had already risen from the third quarter's average of 3 percent to 3.5 percent.

This year's experience does differ from 1985, but in ways which tend to reinforce our optimism. On a month-to-month basis there does not seem to be any discerni-

TABLE I
UNITED STATES ECONOMIC OUTLOOK 1986-1988
Prepared by the U.S. Chamber of Commerce
(Percent change from previous period at seasonally adjusted annual rates.)

	QUARTERS									YEARS			
	Actual			Forecast						Actual	Forecast		
	86:1	86:2	86:3	86:4	87:1	87:2	87:3	87:4	88:1	1985	1986	1987	1988
GROSS NATIONAL PRODUCT													
Real GNP	3.8	0.6	2.9	2.9	2.6	3.0	3.7	4.2	3.3	2.7	2.6	3.0	3.2
Consumption	3.6	6.2	6.5	-1.6	2.7	2.4	2.7	2.1	2.3	3.5	3.9	2.5	2.4
Residential Investment	11.0	14.5	9.7	-10.4	-9.0	-3.2	5.1	7.5	1.3	3.9	8.3	-2.0	1.9
Nonresidential Investment	-15.1	-0.9	-0.1	0.7	2.1	2.6	5.5	5.9	5.7	9.3	-0.9	2.1	4.3
Equipment	-17.0	19.6	3.4	2.2	3.0	3.3	6.5	6.6	6.1	10.1	4.2	4.5	4.6
Structures	-10.8	-35.2	-8.2	-2.8	-0.1	0.8	2.8	4.0	4.7	7.7	-11.2	-3.7	3.6
Exports	7.1	-9.8	9.3	8.6	10.4	11.2	12.5	12.2	12.8	-2.0	1.6	9.1	9.8
Real Net Exports (82$B)	-125.9	-153.9	-163.6	-151.1	-142.3	-135.0	-130.1	-125.4	-118.6	-108.2	-148.6	-133.2	-113.9
Imports	0.2	15.8	14.7	-3.6	0.4	2.4	5.3	5.5	4.5	3.8	9.8	3.5	3.7
Government Purchases	-27.5	11.0	8.1	14.3	-13.8	0.1	7.3	16.5	-14.3	10.9	2.9	2.3	1.3
Final Sales	1.4	5.5	8.7	3.0	4.2	5.8	7.1	7.8	6.0	4.2	5.3	5.5	6.8
Change in Business Inventories (82$B)	39.9	15.1	-5.7	8.8	20.4	22.9	19.3	15.9	30.3	9.0	14.5	19.6	24.1
Industrial Production	-0.3	-2.9	2.3	2.4	2.6	3.7	4.8	6.4	3.9	2.6	0.5	2.9	3.8
New Car Sales (mill.)	10.6	11.2	13.2	10.4	10.0	10.7	10.8	11.2	11.0	11.2	11.4	10.7	11.0
Domestic Car Sales (mill.)	7.8	8.1	9.7	7.2	7.2	7.8	7.9	8.0	7.8	8.2	8.2	7.7	7.9
New Housing Starts (mill.)	1.99	1.91	1.75	1.65	1.56	1.61	1.66	1.68	1.63	1.74	1.83	1.63	1.65
EMPLOYMENT, WAGES AND PRICES													
Civilian Unemployment Rate (%)	7.1	7.2	6.9	7.0	7.1	7.0	6.9	6.6	6.5	7.2	7.0	6.9	6.5
Compensation	3.0	2.3	2.5	2.8	3.4	3.5	3.7	4.0	4.6	4.0	3.0	3.2	4.3
Productivity	4.3	0.4	0.2	1.6	0.6	1.4	1.8	1.9	1.1	0.5	1.0	1.1	1.3
Unit Labor Costs	-1.6	2.2	2.2	1.0	2.8	2.2	1.9	2.0	3.5	3.7	2.0	2.1	3.0
Consumer Price Index	1.4	-1.7	2.6	2.8	2.7	3.1	3.1	3.3	3.4	3.5	1.9	2.6	3.2
Implicit GNP Deflator	2.5	1.8	3.6	1.8	2.6	2.9	2.9	2.9	3.0	3.3	2.7	2.7	3.0
Prime Interest Rate (%)	9.4	8.6	7.9	7.5	7.3	7.1	6.8	6.7	6.7	9.9	8.3	7.0	7.1
3-mos. Treasury Bill Rate (%)	7.0	6.1	5.5	5.3	5.0	4.7	4.4	4.5	4.6	7.5	6.0	4.7	4.7
Corporate Bond Rate (%)	9.6	9.0	8.8	8.7	8.4	8.0	7.8	7.7	7.6	11.4	9.0	8.0	7.5
Real Personal Disposable Income	6.4	7.2	-2.6	1.4	4.7	1.1	1.6	1.4	6.0	1.4	3.2	2.0	2.5
Profits from Current Production ($B)[1]	207.3	199.9	202.2	189.6	172.5	172.5	179.3	188.1	199.8	189.0	199.7	178.1	200.6
GOVERNMENT FISCAL POLICY ($B)[2]													
Unified Receipts										736	769	835	925
Unified Outlays										937	990	1020	1090
Unified Deficit										-201	-221	-185	-165

[1]After-tax corporate profits with inventory valuation and capital consumption adjustments.
[2]Unified budget figures on a fiscal year basis. FY85 and FY86 data are actual.

SOURCE: U.S. Chamber of Commerce, Forecasting Section, using the Washington University model of the U.S. economy.

FORECAST ASSUMPTIONS

This month's forecast contains the latest revisions to the National Income and Product Accounts for the third quarter of 1986. The forecast incorporates provisions of the recently enacted tax reform plan. The nation's money supply M(1) is assumed to grow by 14.3 percent during 1986, 9.8 percent in 1987, and 6.3 percent during 1988. The trade weighted exchange value of the dollar falls by 16.3 percent in 1986, 3.0 percent in 1987, and 5.1 percent in 1988. The price of imported oil averages $14.00 per barrel in 1986 and $15.00 per barrel in 1987 and 1988. The federal minimum wage is not expected to increase.

ble pattern in the rate of growth of consumer installment credit outstanding. However, on a year-ago basis, the rate of increase in consumer credit outstanding has been slowing steadily for the past two years, despite the fact that it remains at double digit levels. Another fact that has not received much attention is that the delinquency rate on consumer installment loans, after reaching a peak in May and June, dropped sharply during the third quarter and is now at rates comparable to the lowest reached in 1985. Moreover, the Mortgage Bankers Association has just reported that the mortgage delinquency rate has fallen to its lowest level in two-and-a-half years.

Finally, three factors that we mentioned in November 1985 with regard to the consumer debt burden are worth repeating. Firstly, although debt burdens have increased, so has household net worth. Secondly, the debt to income ratio exaggerates the burden of debt because of the continued convenience use of credit cards. Surveys show that as many as half of the users of bank credit cards pay their bills in full every month. Estimates place the overstatement on the debt/income ratio resulting from this factor alone at about one percentage point. Thirdly, demographic trends are compatible with the increase in indebtedness that we are now witnessing. The life-cycle theory of consumer behavior holds that younger households borrow heavily to purchase homes and consumer durables. As the proportion of the population in the 25 to 44 age bracket rises, so does household indebtedness.

Nevertheless, there is reason to believe that the first half of 1987 will be weaker than the second half of that year. However, it must be emphasized that this in no way means that a slump or recession is in the making. Despite all the mitigating circumstances mentioned above, it remains a fact that the ratio of consumer debt to income has continued to reach new highs, and that the delinquency rate on consumer installment credit is significantly above the 1984 lows. However, much of the weakness during the first half of next year is likely to stem from the investment sector as a result of the effects of tax reform on both residential and nonresidential investment. Residential investment is anticipated to decline by 2 percent in 1987 while investment in nonresidential structures falls by 3.7 percent.

Despite the third quarter increase in the merchandise trade gap, we continue to expect that the foreign trade sector will become a net plus to the economy during the next two years. Real exports are expected to rise by 9.1 percent in 1987 and 9.8 percent in 1988, following a 2 percent decline in 1985 and an anticipated 1.6 percent increase this year. Real imports should increase by 3.5 percent and 3.7 percent in the next two years, respectively.

Some industries are already reporting significant increases in export orders. For example, orders for paperboard have risen by 18.5 percent, pharmaceuticals orders rose by 14.7 percent, and orders for electrical parts and metalworking machinery have both increased by 13.8 percent. The value of U.S. exports of agricultural products rose by 5 percent during the third quarter despite the fact that the overall increase in exports was insignificant. Moreover, exports of some commodities, such as wheat, cotton, rice and corn, have enjoyed very large increases. Although nonfarm exports were unchanged in the third quarter, most of this lackluster performance can be accounted for by a 48 percent drop in exports of nonmonetary gold, a reflection of the sharp increase in this category of exports during the second quarter when Japan was importing gold for minting commemorative coins. Exports of civilian aircraft to Brazil and Australia contributed to a 58 percent increase in this category of exports, while exports of business and scientific machinery and chemicals also contributed substantially to the rise in exports. On the import side, slower growth in consumer spending will reduce the demand for imported goods.

Our forecast for the next two years places the increase in real gross national product at 3.0 percent in 1987 and 3.2 percent in 1988. However, there are significant risks to the outlook. Tax reform has all but ensured that the investment sector will remain weak. While stronger growth is expected to resume after mid-1987, the increase in investment remains lackluster at best. As the article that follows explains, the treatment of capital gains should be improved to spur investment. But the risk that efforts to reduce the budget deficit may take the form of calls for tax increases is still very real. The recently elected Speaker of the House, Congressman Wright, has already suggested that the second stage of the reduction in personal income tax rates not be implemented as scheduled in 1988.

NEXT YEAR'S TAX BILL: FIX CAPITAL GAINS*

by
*Cesar V. Conda***

While the new tax reform bill should be a net plus to the overall economy in the long-run, several of its provisions – including the onerous tax treatment of capital gains – must be corrected. The bill's repeal of the Federal capital gains differentials for individuals and corporations will result in staggering increases in effective tax rates on

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capital gains. Increasing the capital gains tax will have a serious negative impact on investment and risk-taking, entrepreneurship, mobility of capital, international competitiveness and Federal tax revenues. Fixing capital gains should be the first order of business in next year's "Technical Corrections Act of 1987."

The One-Two Punch

Under the new tax code, the taxation of long-term capital gains will suffer from a "one-two" punch – first at the Federal level and again at the state level. On the Federal level, the 60 percent individual capital gains exclusion from ordinary income is repealed, raising the top federal capital gains tax rate from 20 to 28 percent. Capital gains tax rates in lower brackets will rise considerably more. For example, in the 1986 marginal tax bracket of 42 percent, capital gains are taxed at 16.8 percent, while the rate in 1987 rises to 28 percent and after that as high as 33 percent. Corporate capital gains will be taxed at the same rate as all other corporate income, with the maximum rate rising from 28 percent to 34 percent. Thus, individuals and corporations in the highest tax brackets will experience increases in federal capital gains taxes of 40 percent and 21 percent, respectively.

But to this must be added the effect of state income taxes. Most states conform their tax codes to the Federal tax base. Ending the Federal capital gains differentials will automatically require that the states do likewise. Consequently, if state income tax rates are not lowered, capital gains will be exposed to the maximum tax brackets. For most states, the effective tax rates on individual capital gains will rise from the 20 to 22 percent range to 36 to 37 percent (see Table 1). Similarly, the top effective tax rate on corporate capital gains will rise to the 39 to 40 percent range in most states.

Consider the plight of a New York state investor in the top income tax bracket. Under the old tax code, this investor paid an effective capital gains tax rate of only 22.7 percent (see Table 2). Under the new tax code, this tax rate rises sharply. The top Federal (28 percent) and state (9.72 percent) capital gains tax rates boost the effective tax rate to 37.72 percent – a 66 percent increase. For New York investors in the range of the phaseout of the 15 percent bracket and of the personal exemption (taxable income between $71,900 and $149,000 for joint filers and $43,150 and $89,560 for single individuals), the effective tax rates (33 percent Federal tax and 9.05 state tax) will rise to 42.05 percent after 1987 – a staggering 85 percent increase.

Moreover, elimination of the Federal differentials will result in a wide variation in effective capital gains tax rates from state to state. Today, the effective top tax rate on individual capital gains ranges from 20 percent in states with no capital gains tax to only 22 to 23 percent in high tax states. Tax reform would widen the rate variation between states from 28 percent to a theoretical high of 40 to 42 percent. As a consequence, wealthy individuals and corporations will have a powerful incentive to move to low tax states.

TABLE 1

MAXIMUM EFFECTIVE INDIVIDUAL CAPITAL GAINS TAX RATES*
(Adjusted for Effect of Federal Deductibility)

State	Highest State Bracket (%)	Effective Old Tax (%)	Effective New Tax (%)	Percentage Increase
New York	13.5	22.7	37.72	66.1
Iowa	13.0	22.6	37.36	65.3
West Virginia	13.0	22.6	37.36	65.3
California	11.0	22.2	35.92	61.8
District of Columbia	11.0	22.2	35.92	61.8
Hawaii	11.0	22.2	35.92	61.8
Montana	11.0	22.2	35.92	61.8
Delaware	9.8	21.96	35.26	60.56
Maine	10.0	22.0	35.2	60.0
Massachusetts	10.0	22.0	35.2	60.0
Oregon	10.0	22.0	35.2	60.0
Minnesota	14.0	22.8	35.08	53.8
Kansas	9.0	21.8	34.48	58.16
North Dakota	9.0	21.8	34.48	58.16
New Mexico	8.5	21.56	34.12	58.2
Ohio	8.3	21.66	34.0	56.9
Arizona	8.0	21.6	33.76	56.3
Colorado	8.0	21.6	33.76	56.3
Wisconsin	7.9	21.58	33.69	56.1
Maryland	5.0	21.5	33.6	56.3
Utah	7.75	21.56	33.58	55.7
Idaho	7.5	21.56	33.4	54.9
Arkansas	7.0	21.4	33.04	54.4
Connecticut	7.0	23.5	33.04	40.5
South Carolina	7.0	21.4	33.04	54.4
Georgia	6.0	21.2	32.32	52.5
Kentucky	6.0	21.1	32.32	52.5
Louisiana	6.0	21.2	32.32	52.5
Missouri	6.0	21.2	32.32	52.5
Oklahoma	6.0	21.2	32.32	52.5
Virginia	5.75	21.13	32.14	51.9
Nebraska	5.4	21.08	31.9	51.3
Michigan	4.6	21.0	31.32	49.1
New Jersey	3.5	20.7	30.52	47.4
Indiana	3.0	20.6	30.16	46.4
Illinois	2.5	21.25	29.8	40.2
Rhode Island	22.21% of Federal			
Vermont	26.50% of Federal			

States Which Have No Capital Gains Tax

Alabama	Mississippi	North Carolina	Tennessee
Alaska	Nevada	Pennsylvania	Texas
Florida	New Hampshire	South Dakota	Washington
			Wyoming

*This table assumes that all states will repeal existing preferences for capital gains.
Source: U.S. Chamber of Commerce

The correct solution would be for the states to either cut their income tax rates or restore the differentials. However, as recent events in New York illustrate, there are serious political hurdles in doing so. For months, New York government officials have predicted that the state would reap a $2 billion windfall from the change in the

Federal tax code unless they adjusted their tax rates downward. It is estimated that 50 percent of this windfall would come from the automatic increase in capital gains taxes. Many argue that the capital gains tax must be reduced in order to prevent capital flight. However, others believe that the entire windfall should be redistributed to the poor through tax cuts or increased welfare spending. Should the redistributionists succeed in framing the issue in terms of "rich" versus "poor," the prospects for tax rate reductions in New York and in other states will be greatly diminished.

TABLE 2

NEW YORK STATE TAX ON LONG-TERM CAPITAL GAINS FOR TOP TAX BRACKET

	1986	1988
(1) Top Federal income tax rate	50.0%	28.0%
(2) Portion not excluded for capital gains	× 0.4%	—
(3) Top Federal capital gains tax rate	20.0%	28.0%
(4) Top New York State tax rate	13.5%	13.5%
(5) Portion not excluded for capital gains	× 0.4%	—
(6) Top State capital gains tax rate	5.4%	13.5%
(7) Effect of Federal deductibility	× 50%	× 72%
(8) Effective New York State tax rate	2.7%	9.72%
(9) Effective Federal-State tax rate (8) + (3)	22.7%	37.72%

Source: U.S. Chamber of Commerce

The Economic Impact

Sharp increases in the effective tax rates on capital gains will offset some of the positive economic effects of lower marginal tax rates on salary income. First, individual investment, particularly in those investment activities that involve the most risks, would feel the sharpest impact of the change. Investment in risk capital is an important force in spurring technological innovation and enhancing productivity. However, effective capital gains tax rates approaching 40 percent – almost double the effective tax rate under prior law – will reduce risk capital investment activities by individuals.

Past experience shows the devastating impact of capital gains tax hikes on risk capital investing. In the early 1970s, the maximum tax rate on Federal capital gains was doubled from 25 percent to 49 percent. The Federal and state increase produced a top effective tax on long term capital gains of more than 55 percent. Reducing the after-tax return to risk capital investing caused risk capital to dry up. For example, the amount dedicated to organized venture capital (capital invested in new small companies with growth potential) fell from $171 million in 1969 to a low of $10 million in 1975. Overall, new capital raised through initial public stock offerings crumbled from $2.6 billion in 1969 to a bare trickle of $51 million in 1974. By contrast, after the capital gains tax reductions in 1978, there was a veritable explosion in risk capital investment with over $4.5 billion raised through venture capital companies in 1983. Likewise, new capital raised through initial public stock offering increased to $12 billion in 1983.

Second, high capital gains tax rates impede the free flow of investment capital as investors are discouraged from realizing their capital gains. This is known as the "lock-in" effect. Capital must be mobile in order to be efficient. Moreover, reduced mobility of capital does the most harm to promising growth companies. If funds are "locked-in" in existing investments, Americans are denied the creation of new technologies, new plant and equipment and new jobs.

Third, the taxation of capital gains raises the fundamental issue of tax neutrality between savings (investment) and consumption. Our tax law continues to impose multiple layers of taxation on income that is saved and invested. An individual's return from investment in commercial enterprises is taxed once at the corporate level and then again at the individual level resulting in a double tax on investment. Furthermore, the Code taxes investment income twice by taxing both the future income stream and the capitalization of that stream (the capital gain). Thus, raising the capital gains tax rate reduces the after-tax return to investment relative to consumption. Policymakers should strive to eliminate this tax bias against savings and investment.

Capital Gains and International Competitiveness

Industrial innovation, technological advancement and research and development are vital to the international competitiveness of U.S. industries. The adoption of new technology depends on investment. The capital gains differential, and its positive effect on investment in recent years, has helped the U.S. keep pace with our competitors – particularly in the high-technology race.

Under the new Code, the U.S. tax treatment of long-term individual capital gains ranks second to last among both the major industrialized countries and the high-growth Pacific Basin countries (see Table 3). In fact, some of our major international competitors like Japan, West Germany, Taiwan, Italy and South Korea, exempt long-term capital gains from federal taxation.

Chasing Illusory Tax Revenues and Income Redistribution

Sound economics and irrefutable empirical evidence make a powerful case for reducing – and even abolishing – the tax on capital gains. In fact, most of the congressional tax writers acknowledge the case against increasing the tax on capital gains. Unfortunately, the tax writers are essentially politicians, and politicians are driven more by sound politics than by sound economics. In this year's tax reform debate, sound politics meant making the distributional effects of tax reform appear more beneficial for the middle class than for the wealthy.

Under the Joint Committee on Taxation's (JCT) static

revenue model (i.e., rate reductions are assumed to have no impact on incentives, economic growth and the tax base), the dramatic reduction in the top marginal tax rate to 28 percent would have produced a more generous percentage reduction in the income tax liability for the rich than for the middle class. Raising the tax on capital gains was, in part, an attempt to offset this perceived inequity. Based on the JCT's static revenue model, increasing the capital gains tax rate increases the amount of capital gains taxes paid by upper-income taxpayers. As a consequence, after 1987, the upper-income classes ($50,000 and above) receive an average reduction in income tax liability of only 2 percent while the middle-income classes ($20,000 to $50,000) receive a 9 percent average reduction.

TABLE 3

COMPARISON OF INDIVIDUAL TAXATION OF CAPITAL GAINS ON PORTFOLIO STOCK INVESTMENTS IN ELEVEN INDUSTRIALIZED & SIX PACIFIC BASIN COUNTRIES

Industrialized Countries

	Maximum Short-Term Capital Gains Tax Rate*	Maximum Long-Term Capital Gains Tax Rate*	Period to Qualify for Long-Term Gains Treatment
United States[1]	28%	28%	Six Months
Australia	61%	Exempt	One Year
Belgium	Exempt	Exempt	None
Canada	17%	17%	None
France[2]	16%	16%	None
Germany	56%	Exempt	Six Months
Italy	Exempt	Exempt	None
Japan	Exempt	Exempt	None
Netherlands	Exempt	Exempt	None
Sweden	50%	20%	Two Months
United Kingdom[3]	30%	30%	None

Pacific Basin Countries

	Maximum Short-Term Capital Gains Tax Rate*	Maximum Long-Term Capital Gains Tax Rate*	Period to Qualify for Long-Term Gains Treatment
United States[1]	28%	28%	None
Hong Kong	Exempt	Exempt	None
Indonesia	35%	35%	None
Malaysia	Exempt	Exempt	None
Singapore	Exempt	Exempt	None
South Korea	Exempt	Exempt	None
Taiwan	Exempt	Exempt	None

[1]1988 capital gains tax rate
[2]Gains from proceeds of up to $27,237 (FF 251,500) are exempt from taxation in a given taxable year.
[3]The first $7,140 (£5,600) of gain is exempt annually.
*State, provincial and local tax rates not included.

Source: Arthur Anderson & Co., June 1985

However, raising the tax on capital gains will, over the long-run, produce the exact opposite of what the tax writers intended. This is because higher capital gains tax rates reduce taxpayers' willingness to realize capital gains, thus reducing the amount of tax revenue the Federal government actually receives. Cutting the tax would produce more federal tax revenue and increase the proportion of total taxes borne by the wealthy. The evidence from the 1978 capital gains rate reduction proves this point. The reduction in the maximum capital gains tax rate from 49 percent to 28 percent led to an increase in capital gains taxes paid by all income classes (see Table 4). More importantly, net long-term capital gains paid by the wealthy with adjusted gross incomes of over $500,000 were $1.8 billion in 1978 and $4.2 billion in 1981. This constitutes a 130 percent increase in taxes paid even though the tax rate fell by 43 percent.

TABLE 4

NET LONG-TERM CAPITAL GAINS (1978-1981)

Net Income Class (Thousand)	Net Long-term Gains ($Billions) 1978	1981	Percent Change 1978-1981
0-25	$9.7	$13.2	36.1%
25-50	9.0	10.2	13.3
50-100	6.6	11.2	69.7
100-500	8.6	19.0	120.9
500-above	3.7	14.9	302.7

Source: Internal Revenue Service

A recent econometric study by Lawrence B. Lindsey analyzing the data on capital gains tax rates, realizations and household wealth found that "a one percentage point reduction in the capital gains tax rate resulted in 6.2 percent more net gains realized. The implication of this finding is that revenues from capital gains taxes are maximized when the capital gains tax rate is 16 percent. At higher tax rates, the revenue gained from taxing realized gains at higher rates is more than offset by a reduction in the amount of capital gains realized."

Fixing Capital Gains

Capital gains can be fixed by restoring the differential and reducing the tax rate or, at the very least, indexing capital gains. There are two basic considerations in determining the level of the capital gains tax rate. One is the revenue effect of a given tax rate and the other is the economic efficiency effect of a given tax rate. They are not necessarily the same tax rate. Empirical evidence suggests that both rates are lower than the previous 20 percent tax rate. As mentioned earlier, Lindsey found that 16 percent is the revenue maximizing capital gains tax rate. In contrast, a zero tax rate may be optimal from an economic efficiency standpoint. Given today's Federal deficit constraints, 16 percent may be the lowest rate that can be achieved at this time. Under the tax reform law's lower marginal tax rates, a 43 percent exclusion from ordinary income is required to cut the top Federal capital gains tax rate from 28 to 16 percent. Likewise, the corporate capital gains tax should be reduced to the previous alternative rate of 28 percent—or lower depending on econometric estimates of the revenue maximizing tax rate.

At a very minimum, capital gains should be indexed to the extent that such gains are inflationary. During the 1970s, high inflation led people to pay taxes on nominal capital gains and sometimes real losses (i.e., taxable gains when adjusted for inflation were often actual losses). Some argue that tax cost-basis indexing does nothing to encourage risk-investment. Nonetheless, indexing is necessary because taxing inflationary gains is inherently unfair.

Conclusion

In conclusion, tax reform's reduction in marginal tax rates is a major victory. Lower tax rates reduce the tax bias against work, savings and investment. However, constrained by the fantasy world of static revenue neutrality, the tax writers made tax changes that will tend to offset some of the positive economic effects of lower rates. Let's not deny Americans the full benefit of tax reform. The restoration of the Federal capital gains differentials for individuals and corporations will reduce the tax bias against savings and investment, solve the problem of the "one-two" punch from Federal and state capital gains taxation (since most states would automatically restore the state exclusion), boost U.S. international competitiveness and promote a fairer distribution between the middle class and the wealthy. Capital gains is the one area that the President and the Congress should strive to correct next year.

A MEDICARE CATASTROPHE IN THE MAKING

by
William Orzechowski

President Reagan's philosophy of reducing government intervention in the private sector is being undermined. In November of this year, the Department of Health and Human Services (HHS) released a report which recommended expanding the government's role through a new federal catastrophic insurance plan. The adoption of this recommendation would take insurance coverage now provided in the private sector and shift it to the public sector. In so doing, the Administration is stepping backwards from its commitment to privatization.

The substance of the HHS recommendation stands in contrast to President Reagan's 1986 State of the Union address. President Reagan asked HHS to conduct an Administration study of "how the private sector and government can work together to address the problems of catastrophic health care." In response to this presidential directive, HHS is expected to offer a solution which transforms a highly competitive market composed of over 200 private firms into a government monopoly.

The issue arises because, under the current Medicare system, a patient's bill can accelerate sharply after 60 days of hospital care. While all hospital stays are subject to a deductible of $524, the patient must pay co-insurance fees of $123 a day for the 61st to 90th days of a hospital stay and $246 each day for the use of "lifetime reserve days" – an additional 60 days of coverage which may be used once during the individual's lifetime. Fewer than one percent of the elderly ever exceed hospital stays of 60 days. However, after Medicare coverage is exhausted, the patient is on his own. Nevertheless, private insurance is widely available to supplement Medicare coverage.

In fact, about 70 percent of the elderly are covered by supplemental health insurance or "Medigap" policies. About half of the remaining elderly have coverage provided through Medicaid, and private coverage is available to the rest.

In most states, catastrophic health insurance policies are required to provide a minimum of 365 days of hospital care (a rare event) beyond the Medicare limits, and the policies cover the Medicare deductible and co-insurance fees as well. Insurance coverage is also available to the elderly through subscriptions to health maintenance organizations (HMOs) which provide medical services in return for a fixed monthly fee. Private insurers are also beginning to experiment with long-term nursing care policies which Medicare does not provide.

In the face of this thriving competitive insurance industry, HHS is expected to recommend a new federal program. Coverage would be offered through Medicare to those elderly who agree to pay an additional premium of $60 per year. This coverage would limit the beneficiary's out-of-pocket expenses for all covered services to $2,000 per year. The coverage is to be unsubsidized, with the $60 premium intended to cover all costs.

HHS expects the federal catastrophic program to eventually take over the private Medigap market. In effect, they are working on the assumption that a government monopoly will charge a lower price than a private, competitive industry. To our knowledge, without large taxpayer subsidies, there are few or virtually no instances of this phenomenon. In a forthcoming study by the National Chamber Foundation, a separate research affiliate of the U.S. Chamber of Commerce, shows that it is highly unlikely that catastrophic medical care can be provided without subsidies.

The Foundation's study demonstrates that the costs of the federal program have been seriously underestimated. Apparent savings are due to: (1) the failure to account for all costs, (2) inadequate comparisons with private insurance plans and, (3) a failure to take account of bureaucracy and political dynamics.

According to its sponsors, the primary advantage of the

federal plan is economies of scale. It is alleged that the federal plan will lower per unit costs as it takes business away from the private market. The ultimate objective is for the federal government to enroll at least 75 percent of the eligible beneficiaries. According to the HHS actuaries, this is the minimum amount necessary to make the program sound. This would, of course, virtually destroy the private Medigap sector which is about the same size.

In fact, **the economies of scale argument is a hoax.** It is true that costs per unit fall as the size of an enterprise grows. However, there is a point at which maximum efficiency is reached and from there diseconomies of scale emerge. In the Medigap market this optimum organizational size has been shown to be considerably below the behemoth federal model. There are over 200 companies now writing Medigap policies. If economies of scale were such a major factor, the industry would be dominated by a few firms or a private monopoly, but clearly it is not.

HHS cost comparisons are flawed. HHS claims that its $60 annual premium underprices current private plans. However, the private plans used in the comparison offer more coverage. For example, private policies cover Medicare's $492 first day deductible which is frequently incurred. The private policies also cover the initial supplementary medical insurance (SMI) co-insurance fees and often the SMI deductible. The federal catastrophic plan does not include coverage for such items. In fact, there are private companies that offer policies with virtually the same coverage as the federal plan for less than $60 a year in premiums.

HHS underestimates the costs of the federal program. For example, without substantial subsidy, the federal insurance plan will have to be aggressively marketed. Since the federal plan's premium is expected to be unsubsidized, such costs will be large. Only if the federal government makes it mandatory to join the program can such costs be eliminated. However, the consumer would lose his freedom of choice, and it stretches the imagination to believe that a government monopoly with mandatory participation could do a better job than a competitive market.

Most important of all, HHS fails to take account of bureaucracy and political dynamics. Physicians, hospitals and patients under the federally-guaranteed plan would be inclined to opt for more expensive and prolonged care even though it may not be required. The managerial and administrative inefficiency associated with public bureaucracy would have to be covered as well. Have we forgotten the Grace Commission? Our elected representatives would be under enormous strain to expand benefits without increasing premiums. Costs would soar beyond original estimates, and the next generation would be stuck with liabilities in the trillions as is the case with the existing Medicare plan.

For example, the Medicare program itself was originally estimated to cost $4 billion by 1980; it actually cost $32 billion that year – an eight-fold increase. To keep this program solvent for the next generation means that the Medicare payroll tax will have to nearly triple, making it equal to about half of today's combined Social Security and Medicare payroll tax. This translates into a combined employer-employee payroll tax of nearly 25 percent. The political dynamics of federal catastrophic insurance will only add to the climbing payroll tax burden which is already a bulwark against economic growth.

Given a rich history of bureaucratic failure, it is inconceivable that the federal government can do the job better than the private sector. Bureaucratic inefficiency and political pressures for program expansion would lead to spiraling costs that would be passed onto the general taxpayer. The result would be a time bomb set for a massive cost explosion.

The truth is that the private sector is presently doing a good job. For example, private HMOs in return for taking the responsibility of providing Medicare, receive a government payment that covers 95 percent of the average cost per beneficiary under Medicare. To attract elderly customers under this program, most HMOs offer catastrophic coverage at no extra charge. In other words, HMOs are providing the health care obtainable under Medicare coverage, plus catastrophic coverage, for only 95 percent of what it costs the government to provide Medicare alone.

Finally, the public should not be fooled by the misleading claims of the federal program's sponsors. Health and Human Services has stated that for "five dollars a month" we can give the elderly "real peace of mind." The impression being given is that the new catastrophic federal program will cover all medical needs of the elderly. The truth, of course, is that the plan has a smaller range of coverage than present private programs.

On a more serious note, they are leading the public to believe that heavy financial burdens such as long-term nursing care will be covered by the new federal program. This is simply not true. However, through the development of Health Care IRA's or alternative tax credit mechanisms, enterprises and individuals could be encouraged to develop a private insurance system for long-term nursing care. Instead of focusing upon ways to develop such private alternatives, HHS is giving the erroneous impression that its new catastrophic plan is going to do the job.

Given the existence of a vigorous and competitive private catastrophic medical insurance system, there is no need for a new federal program which would mock the whole notion of privatization. Secretary Bowen should be

encouraged to drop such a plan and instead, recommend, in line with President Reagan's request, further ways to stimulate the development of private medical insurance systems. Doing so will enable us to avoid the grave financial difficulties associated with current entitlement programs, furthering President Reagan's goals of reducing government spending and interference in the private sector and expanding the role of the free market.

TRENDS IN COMMERCE
NOTES ON TABLE II
DECEMBER 1986/JANUARY 1987

by
*Martin Lefkowitz**

Gross National Product (GNP) – The revised estimate of Gross National Product – the total value of goods and services produced in the economy – shows that third quarter GNP grew at a 2.8 percent annual rate. Final sales, after adjusting for inflation, rose at a robust 4.5 percent annual rate, with one-half of the increase attributed to auto sales. However, most of the increase in auto sales came from dealer inventories rather than current production. Consumer spending remained strong, growing at a 6.7 percent rate in the third quarter. Increases were also evident in residential investment and government spending. The third quarter data continued to reflect a widening of the trade deficit, with exports rising by 13.3 percent while imports increased at a much faster rate of 17.3 percent.

The Services Sector – Employment in service sector establishments increased by 266,000 jobs in October and is now 2.4 million jobs above its year-ago level. This compares with a decline of 21,000 jobs in the goods-producing sector over the last twelve months. Over the past year, the manufacturing sector has lost 110,000 workers. All of the job growth in the economy during the past year has been in services industries.

Consumer purchases of services increased by 0.3 percent in October. Major domestic airlines reported that revenue passenger miles flown, that is, the number of passengers multiplied by the miles flown by each passenger, reached 22.3 billion in October, an increase of 17 percent from its year-ago level. Over the past ten months, domestic passenger travel has increased 12.6 percent and available seat miles were up 12.7 percent. International passenger traffic declined 2.4 percent in October compared to October of last year.

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Money Supply – The nation's money supply – as measured by M1, currency in circulation plus demand deposits – increased by 1.2 percent in October and was 14.2 percent above its year-ago level. In the six months ended in October, M1 was up at an annual rate of 17.1 percent. This is considerably above the Fed's target range of three to eight percent.

Employment – The civilian unemployment rate remained at 7.0 percent in November for the third consecutive month. Employment hit a new record in November, with 110.4 million persons at work, an increase of 2.4 million persons since November of 1985. Nonagricultural payroll employment – as measured by the monthly survey of establishments – rose by 250,000 to 101.1 million. The largest over-the-month increase in the service-producing sector took place in the services industry, with both business and health services contributing to the increase. In November, the civilian labor force increased to 118.7 million. In the first four years of this recovery, nonfarm payroll employment has grown by 12 million, and total civilian employment has increased by 11 million.

Consumer Price Index – The Consumer Price Index for all urban consumers (CPI-U) rose by 0.2 percent in October, following a 0.3 percent increase in September. This decline was mainly attributable to the 2.2 percent falloff in energy prices. Over the past ten months the index rose at a seasonally adjusted annual rate of 0.7 percent. Consumer prices were held down by energy prices which were falling at a 22.7 percent annual rate. Excluding the decline in the prices of energy products, prices increased at a 3.8 percent annual rate over the past ten months, about the same rate as in 1985.

The Producer Price Index for finished goods increased by 0.2 percent in November after rising 0.3 percent in October. The November increase was held down because of lower energy prices which offset large increases in food and auto prices. Over the past year, finished goods prices at the wholesale level have declined 1.9 percent. The intermediate goods index rose by 0.2 percent, the result of a rise in energy prices, which rose by 0.3 percent from October to November. However, the crude goods index remained unchanged in November, after jumping 1.6 percent in October. Crude food prices fell 0.2 percent in November following a 2.6 percent rise in October.

Housing Starts – Privately owned housing units were started at a seasonally adjusted annual rate of 1,648,000 units in October, virtually unchanged from the September level. October housing starts were nearly 8 percent below the October 1985 level. The data reflected a continued decline in apartment construction, (down over 35 percent since last April), which many attribute to tax reform legislation, while single-family home construction increased by one percent. In October, new home starts de-

TABLE II
TRENDS IN COMMERCE

	Current Period		Previous Period	Year Ago	Percent Change From Previous Period	Percent Change From Year Ago
Population (Millions) [a]	Oct/86	242.2	242.0	239.3	0.0	1.2
Gross National Product ($B)	III/86	4,240.7	4,175.6	4,030.5	1.6	5.2
Gross National Product (82$B)	III/86	3,686.4	3,661.4	3,603.8	0.7	2.3
Money Supply (M1) ($B)	Oct/86	701.2	693.1	614.2	1.2	14.2
Money Supply (M2) ($B)	Oct/86	2,764.4	2,740.2	2,538.9	0.9	8.9
PEOPLE AND THEIR MONEY						
Personal Consumption Expenditures ($B)	Oct/86	2,773.0	2,830.1	2,644.0	−2.0	4.9
Personal Consumption Expenditures (82$B)	Sep/86	2,466.7	2,445.2	2,366.5	0.9	4.2
Disposable Personal Income ($B)	Oct/86	2,995.4	2,988.0	2,860.9	0.2	4.7
Disposable Personal Income (82$)	Sep/86	2,604.3	2,611.0	2,523.1	−0.3	3.2
Personal Savings Rate (%)	Oct/86	4.1	2.0	4.5	2.1[b]	−0.4[b]
Civilian Employment (millions)	Nov/86	110.4	110.2	108.0	0.2[c]	2.2[c]
Civilian Unemployment Rate (%)	Nov/86	7.0	7.0	7.0	0.0[b]	−0.0[b]
Average Hourly Earnings	Nov/86	$8.84	$8.80	$8.65	0.2	2.2
Consumer Price Index (All Urban, 67 = 100) [a]	Oct/86	330.5	330.2	325.5	0.2	1.5
Prime Interest Rate (%) December 3, 1986		7.5	8.5	9.5	−0.5[b]	2.0[b]
Retail Sales ($B)	Nov/86	122.3	121.6	115.4	0.5	5.9
SERVICES SECTOR						
Employment in Services (Millions)	Oct/86	75.9	75.6	73.5	0.4	3.3
Consumer Purchases of Service ($B)	Oct/86	1,464.2	1,459.1	1,367.1	0.3	7.1
Consumer Purchases of Service (82$B)	Sep/86	1,184.1	1,183.1	1,142.4	0.1	3.7
Domestic Revenue Passenger Mileage Flown Major Airlines (Billions) [a]	Oct/86	22.3	21.1	19.0	5.7	17.4
BUSINESS PROFITS AND OUTPUT						
Corporate Profits and Cash Flow ($B)						
Before Tax	III/86	241.3	231.3	229.2	4.3	5.3
Profits Tax Liability	III/86	97.4	93.3	95.8	4.4	1.7
Tax Liability as a Percent of Profits	III/86	40.4	40.3	41.8	0.1[b]	−1.4[b]
After Tax	III/86	143.9	138.0	133.4	4.3	7.9
Net Cash Flow	III/86	387.0	380.6	382.8	1.7	1.1
Industrial Production (77 = 100)	Oct/86	125.2	125.2	123.6	0.0	1.3
Capacity Utilization Rate (Mfg.) (%)	Oct/86	79.0	79.6	79.4	−0.6[b]	−7.6[b]
New Housing Starts (thou. units)	Oct/86	1,648.0	1,652.0	1,784.0	−0.2	−7.6
BUSINESS COSTS						
Unit Labor Costs (nonfarm) (77 = 100)	III/86	169.1	168.0	164.4	0.6	2.8
Unit Nonlabor Costs (nonfarm) (77 = 100)	III/86	163.4	161.9	161.4	0.9	1.2
Producer Price Indices (67 = 100) [d]						
Crude Materials	Nov/86	278.4	276.7	304.7	0.6	−8.6
Intermediate Goods	Nov/86	304.9	304.9	318.1	0.0	−4.1
Finished Goods	Nov/86	290.7	290.5	296.4	0.1	−1.9
FEDERAL SPENDING AND DEBT						
Federal Spending Index (67 = 100)	Oct/86	591.1	590.8	596.9	0.1	−1.0
Federal Gov't Gross Debt Outstanding ($B) [a]	Oct/86	2,035.6	2,012.6	1,758.3	1.1	15.8
INTERNATIONAL TRADE						
Exports of Goods & Services ($B)	III/86	368.0	363.0	362.3	1.4	1.6
Imports of Goods & Services ($B)	III/86	476.1	467.5	446.0	1.8	6.7
Balance on Goods & Services ($B)	III/86	−108.2	−104.5	−83.7	3.5	29.6
WHAT'S AHEAD?						
Index of Leading Indicators (67 = 100) [a]	Oct/86	180.5	179.5	171.6	0.6	5.2

NOTE: All data seasonally adjusted unless otherwise noted

[a] Not seasonally adjusted
[b] Percentage point difference
[c] January data is a new series that is not comparable to previous data
[d] Index number not seasonally adjusted, percent change seasonally adjusted

clined in the Northeast and the Midwest, but were up in the South and West. Building permits, an indicator of future activity in the home building industry, were down 3 percent for the month, representing the fourth consecutive monthly decline in permits.

Corporate Profits and Cash Flow – Corporate profits have been sluggish for the past year. Pre-tax profits increased by 4.3 percent between the second quarter and third quarters of 1986. Economic profits, which take into account economic depreciation and adjust for changes in inventory valuation, were up 2.2 percent from their year-ago level. Net corporate cash flow, which includes depreciation allowances, was one percent below the fourth quarter of 1985.

Industrial Production – Industrial production rose 0.6 percent in November, following a 0.1 percent increase in October. Production in November was 0.8 percent higher than its year-ago level. The increases in output occurred in defense, durable and nondurable consumer goods. Industrial production showed no change in the auto and truck industries.

The October capacity utilization rate declined 0.2 percentage points to 79 percent, 2.5 percentage points below its peak level for the current expansion in the summer of 1984. Over the past year, durable goods capacity expanded by 2.4 percent, and nondurable goods capacity increased by 2.8 percent. Mining capacity declined as a result of a falloff in drilling activity and is now at less than half of its 1985 level.

Productivity – Nonfarm business productivity increased at a seasonally adjusted annual rate of 0.2 percent in the third quarter of 1986, compared to a 1.6 percent increase in the previous quarter. Third quarter output rose by 3.2 percent while hours worked declined by 3.0 percent. Manufacturing productivity rose at a 4.2 percent annual rate for the quarter, and output increased at a 4.2 percent annual rate, while hours worked rose by 0.8 percent. This small increase in hours worked coupled with a relatively large increase in output, resulted in a 1.5 percent drop in unit labor costs in the manufacturing sector.

Interest Rates – The prime interest rate is currently 7.5 percent, 2.0 percentage points below its year-ago level. Three-and six-month Treasury bill rates which were 5.2 and 5.4 percent, respectively, in early October also ended the month at very close to that level. Thirty-year Treasury bonds traded at 7.6 percent at the end of October, the same as in late September.

Federal Spending – The "Federal Spending Index," a U.S. Chamber devised measure of the monthly change in federal expenditures, increased to 591.1 in October (1967 = 100), a 0.1 percent increase from the previous month and one percent below the level of October 1985. Federal receipts for October, the first month of fiscal year 1987, increased by 1.9 percent, while expenditures for the same period were actually one percent below the year-ago level. The federal deficit in October was $25.2 billion, $1.9 billion less than the same period last year.

Personal Savings – The personal savings rate was 4.1 percent of after-tax income in October, twice the rate reported in September when consumer spending increased significantly. The October savings rate was the highest in four months.

Retail Sales – Retail sales increased 0.5 percent in November after a 5.2 percent decline in October and a 5.3 percent increase in September. Sales rose 5.9 percent above their level of November 1985. For the past few months, retail sales have been heavily influenced by auto dealer promotions and discounts. Hardware stores, auto dealers, and furniture stores reported double-digit increases in sales this November compared to sales in November of 1985.

Trade Deficit – The U.S. merchandise trade deficit improved greatly in October shrinking to $12.1 billion, the smallest trade deficit since August 1985. The increase in exports was the highest since March 1985. Agricultural exports have picked up, but a large part of the decline in the merchandise trade deficit was due to a significant decrease in imports of manufactured goods. On a goods and services basis, the trade deficit in the third quarter of 1986 was $110.1 billion.

What's Ahead – The composite index of leading indicators, designed to predict future movements in aggregate economic activity, increased by 0.6 percent in October. Five of the 11 indicators available for October were up, and six were down. This indicator has moved up in three of the last four months. The positive contributors to the October increase were money supply, changes in sensitive material prices, an increase in credit outstanding and fewer persons filing for unemployment compensation.

STUDY FORECASTS RAPID GROWTH IN HOUSING INDUSTRY

According to a new study to be released soon by Salomon Brothers Inc., the U.S. housing industry is expected to grow through the end of the decade at levels that exceed current projections. The study, which is the first to dispute widespread projections that housing needs would average about 1.6 million to 1.7 million units per year through the end of the decade, projects that annual housing demand will be 1.9 million units through 1990. According to Salomon's projections, the increase in hous-

ing demand would be felt in other areas of the home building industry such as roofing, lumber, and cement and could, as a result of the increased demand, contribute to GNP growth far more than their current average contribution of 4.5 to 5.0 percent.

PROJECTED CHANGES IN EMPLOYMENT[1] 1984–1995

Most New Jobs	Gain in Thousands
Business services	2,633
Retail trade, except eating and drinking places	1,691
Eating and drinking places	1,203
Wholesale trade	1,088
Medical services[2]	1,065
Professional services[2]	1,040
New construction	558
Doctors' and dentists' services	540
Hotels and lodging places	385
Credit agencies and financial brokers	382
Fastest Growing	**Average Annual Percent Change**
Medical services[2]	4.3
Business services	4.2
Computers and peripheral equipment	3.7
Materials handling equipment	3.7
Transportation services	3.5
Professional services[2]	3.5
Scientific and controlling instruments	2.9
Medical instruments and supplies	2.8
Doctors' and dentists' services	2.6
Plastics products	2.5
Most Rapidly Declining	**Average Annual Percent Change**
Cotton	−4.2
Wooden containers	−3.6
Leather products, including footwear	−2.8
Iron and ferroalloy ores mining	−2.7
Sugar	−2.7
Leather tanning and finishing	−2.6
Railroad transportation	−2.6
Nonferrous metal ores mining, except copper	−2.6
Dairy products	−2.3
Blast furnaces and basic steel products	−2.2

[1]Includes wage and salary jobs, the self-employed and unpaid family workers.
[2]Not elsewhere classified.

Source: Bureau of Labor Statistics

U.S. STANDARD OF LIVING RISES

A joint report recently released by the U.S. Department of Commerce and The Conference Board reveals that Americans have improved their standard of living by about 20 percent over each decade since 1940. The report also stated that the amount of goods and services consumed by the average American has doubled since 1950–spurred by worker productivity which has also doubled since that time. In addition, the report found that the number of Americans who earn a paycheck has risen by 50 percent over the last two decades; real net worth of U.S. households has tripled since 1950, and average family income has risen to about $33,000 from $17,125.

INDUSTRY TRADE DEFICITS 1985

	1985 ($ Billions)	1980–1985 (Percent Change)
Motor vehicles	$39.8	+216%
Apparel, accessories	15.3	+173
Telecommunications, sound equipment	14.4	+336
Miscellaneous consumer goods	10.3	+506
Iron, steel	9.9	+98

Source: Fortune, December 8, 1986

INDUSTRY TRADE SURPLUSES 1985

	1985 ($ Billions)	1980–1985 (Percent Change)
Aircraft, transportation equipment	$11.2	−3%
Office machines, computers	3.8	−55
Professional, scientific instruments	3.4	−15
Specialized industrial machinery	2.2	−255
Synthetic resins, plastics	2.1	−52

Source: Fortune, December 8, 1986.

THE BIG GAINERS AMONG U.S. EXPORTERS

($ Millions)

	April-August 1985	April-August 1986	Percent Change
Paperboard	$713	$845	18.5%
Medical & Pharmaceutical Products	1,133	1,299	14.7
Metalworking Machinery	536	610	13.8
Electrical Parts & Appliances	5,049	5,744	13.8

Source: Businessweek, November 3, 1986.

HOURLY WAGES FOR SELECTED INDUSTRIES

(Production and Nonsupervisory Workers)

Basic steel	$14.08
Railroads	13.02
Motor vehicles, equipment	13.40
Telephone communications	12.80
All construction	12.31
Trucking and terminals	10.79
Machinery	10.57
Stone, clay, glass	10.06
Bakery products	9.91
All manufacturing	9.74
Electrical, electronic equipment	9.68
Hospitals	9.41
All services	8.04
Auto repair	7.51
Banking	7.15
Textile mill products	6.90
Department stores	6.61
Hotels, other lodging	5.81
Apparel, other textiles	5.76
Footwear, except rubber	5.59

Source: U.S. Department of Labor

VALUE OF OUTPUT FOR SELECTED INDUSTRIES

	Percent Change 1982-85	4th Q 85/4th Q 86
Motor vehicles	19.15%	-2.73%
Building materials	19.03	-1.53
Appliances	9.26	1.69
Steel mills	-4.24	-6.92
Aircraft	9.93	3.95
Radio-TV	10.53	7.75
Pulp, paperboard	4.46	6.57
Paperboard boxes	0.56	8.71
Farm machinery	-5.86	-6.20
Newspapers, books	2.00	7.37
Apparel	-0.44	4.25
House furniture	12.52	-2.53
Drugs, soaps	-1.66	9.20
Beverages	-0.19	8.92
Scientific instruments	5.07	3.73

Source: U.S. Department of Commerce

COMMERCE DEPARTMENT REPORTS GROWTH IN STATE PER CAPITA INCOME FOR 1985

According to revised estimates by the U.S. Department of Commerce, average per capita personal income for the United States rose to $13,867 in 1985 as compared to $13,114 in 1984. During 1985, state per capita income ranged from $18,187 in Alaska and $18,089 in Connecticut to $9,187 in Mississippi.

Eight states had per capita incomes 7 percent above the U.S. average, with most of these states concentrated in the New England and Mideast regions of the country. Those states which had low per capita incomes were primarily located in the Southeast, Southwest, and Rocky Mountain regions.

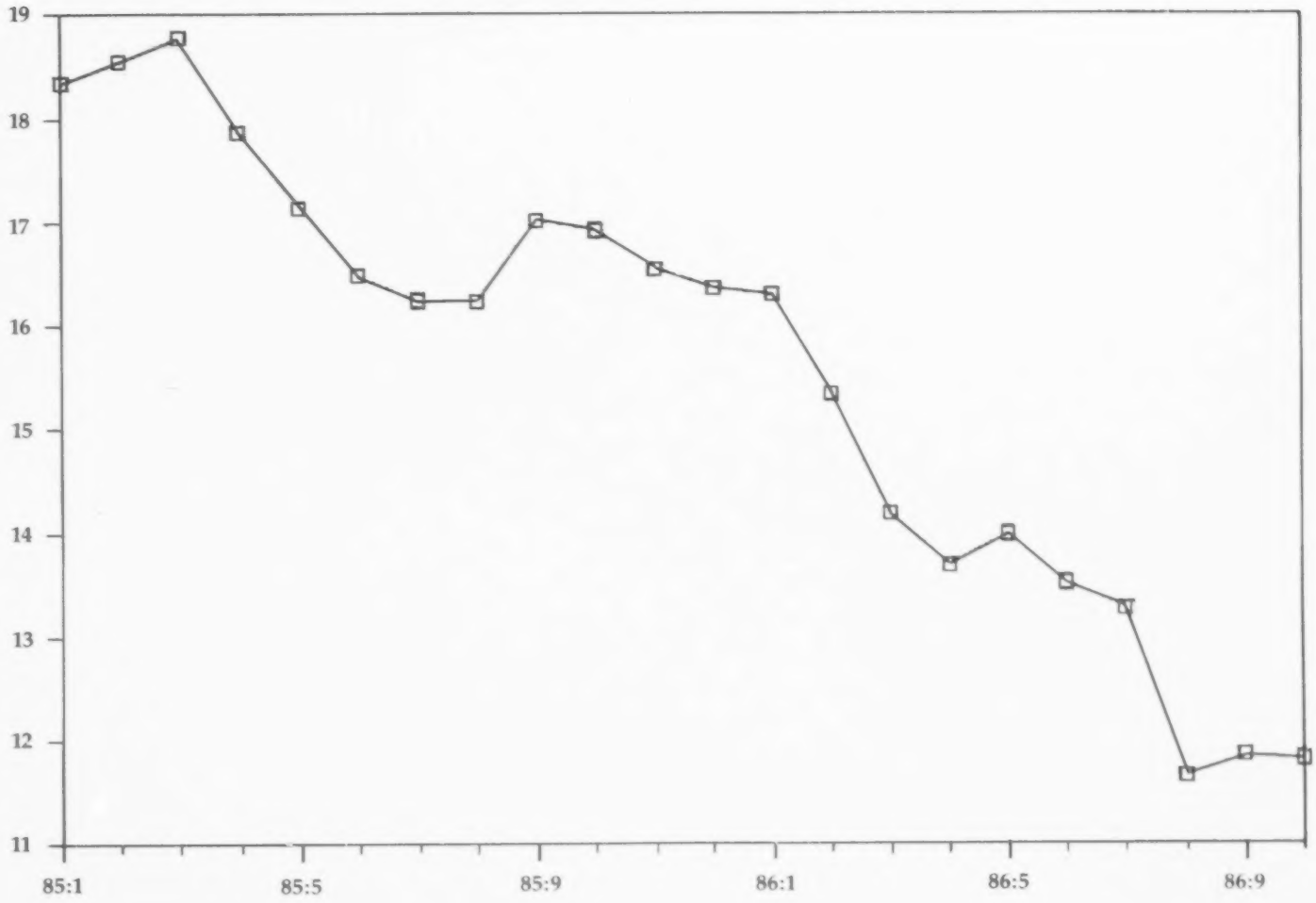
During the 1982–1985 period, per capita personal income increased 20.9 percent nationally. Those states showing the largest percentage gain in per capita personal income during this period included: New Hampshire (+30.6%), Massachusetts (+28.5%), Connecticut (+26.9%), Georgia (+26.7%), New York (+25.5%), New Jersey (+25.3%), North Carolina (+25.1%), Maryland (+24.9%), Virginia (+24.7%), and Maine (+24.2%).

Among those states which had the smallest percentage increase in per capita personal income were: Alaska (+5.1%), Wyoming (+7.0%), Oklahoma (+7.4%), Louisiana (+8.9%), Montana (+8.9%), West Virginia (+12.1%), North Dakota (+14.3%), Washington (+15.2%), New Mexico (15.2%), and Texas (+15.3%).

CENSUS BUREAU REPORT SHOWS POVERTY RATE FELL IN 1985

The Census Bureau, in its annual report on poverty and income, reported that 14 percent of the American population had incomes below the official poverty line during 1985, a decline from 1984. During 1985, median family income rose to $27,735, a 1.3 percent inflation-adjusted gain. The poverty rate among whites fell from 11.5 percent in 1984 to 11.4 percent in 1985; among blacks, it fell from 33.8 percent to 31.3 percent.

Consumer Installment Credit Outstanding
(percent change from year ago)



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ECONOMIC OUTLOOK

Chamber of Commerce of the United States

February/March 1987

POLICY RISKS THREATEN ECONOMY

As the economy enters its fifth year of recovery, all signs point to a continuation of moderate rates of economic growth. We anticipate an increase in real GNP of 3% this year and 3.6% in 1988. The latest data releases show that 1986 ended on a relatively strong note. Increases in personal income, together with the tax reform related rush to purchase big ticket items, contributed to a 2% rise in consumer spending in December. As a result, industrial production increased by 0.5% and the capacity utilization rate rose to nearly 80%. Housing starts also improved significantly, rising by 14% in December and remaining at 1.8 million units in January. This burst of activity led to a decline in the civilian unemployment rate to 6.7% in both December and January. Encouragingly, manufacturing employment also increased for the fourth consecutive month. This performance was accompanied by no noticeable acceleration in inflation as the consumer price index increased by only 0.1% in December.

More importantly, the index of leading indicators posted an impressive 2.1% surge. Some of the indicators which contributed to the increase were building permits, new orders for consumer goods and materials, and contracts and orders for plant and equipment. This improvement presages increased activity this spring and summer.

The sources of economic growth during the next two years are likely to be quite different from what we have experienced so far. The investment sector is expected to make the smallest contribution to GNP growth because it is constrained by the effects of tax reform. Residential investment is expected to rise by 2.8% in 1987 and 2.3% in 1988. Nonresidential investment should increase by only 2.9% this year and 5.9% in 1988.

Consumer spending, which buoyed economic activity in 1985 and 1986 should continue to support economic growth, although it will not be the leading influence it was in the past. Large increases in consumer spending during the last two years have satisfied a significant portion of pent-up demand for durable goods. Moreover, relatively high levels of consumer indebtedness plus the phase-out of the non-mortgage interest expense tax deduction may begin to act as a constraint on both borrowing and discretionary spending. We expect that real consumer spending will rise by 2.5% in 1987 and 2.9% in 1988.

This leaves inventory investment and net exports as the major contributing factors to economic growth this year and next. After falling during the second half of last year, real inventory accumulation is expected to resume, reaching $18.2 billion this year and $29.2 billion in 1988. We anticipate a turnaround in real net exports. The evidence shows that the impact of currency changes does not show up in the trade figures until approximately two years later. For instance, while the dollar began to appreciate in late 1979, net exports did not decline significantly until mid-1982 and did not turn negative until mid-1983. Thus, the dollar's depreciation should soon begin to have a positive effect on real GNP. In fact, this turnaround was evident during the fourth quarter, when exports rose by 13.6% and imports fell by 0.2% (a significant improvement following the third quarter's 17.3% growth rate). As a result, real net exports (exports minus imports – the relevant variable in terms of GNP) rose by $12.3 billion. While one quarter does not make a trend, it should be noted that, with the exception of the months of July and November 1986, the merchandise trade deficit has been on a declining path since May.

Despite our relative optimism, we are concerned about a number of policy risks facing our economy. Chief among our concerns are that: (1) a major tax increase will be enacted; (2) the resurgence in export growth will not be as strong as expected; (3) short-sighted protectionist legislation will be enacted; and (4) excessive growth in the money supply will trigger higher inflation.

The Tax Increase Threat

During the past twenty-two years, government rev-

Dr. Richard W. Rahn, Vice President and Chief Economist.
Ms. Graciela Testa-Ortiz, Director, Forecast Section.

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TABLE I
UNITED STATES ECONOMIC OUTLOOK 1986–1988
Prepared by the U.S. Chamber of Commerce
(Percent change from previous period at seasonally adjusted annual rates.)

	QUARTERS									YEARS			
	Actual		Forecast							Actual		Forecast	
	86:3	86:4	87:1	87:2	87:3	87:4	88:1	88:2	88:3	1985	1986	1987	1988
GROSS NATIONAL PRODUCT													
Real GNP	2.8	1.3	3.3	3.7	4.3	4.5	3.8	3.1	2.6	2.7	2.5	3.0	3.6
Consumption	6.7	-0.1	1.1	2.9	4.0	1.6	3.2	3.0	3.0	3.5	4.1	2.5	2.9
Residential Investment	9.7	6.2	-1.8	-1.6	2.9	6.5	2.2	1.4	0.1	3.9	9.5	2.8	2.3
Nonresidential Investment	-2.1	1.0	3.2	9.1	6.7	8.0	5.5	4.3	4.8	9.3	-1.1	2.9	5.9
Equipment	1.2	4.9	3.9	9.7	8.1	9.3	4.9	3.8	4.5	10.1	4.1	5.1	6.1
Structures	-9.8	-7.2	1.4	7.7	3.1	4.7	7.3	5.5	5.8	7.7	-11.7	-2.4	5.5
Exports	13.3	13.6	10.9	11.6	11.4	8.5	13.3	6.2	6.1	-2.0	2.3	10.8	9.3
Real Net Exports (82$B)	-163.3	-151.0	-148.2	-144.0	-142.9	-141.0	-134.2	-131.7	-127.7	-108.2	-148.6	-144.0	-130.3
Imports	17.3	-0.2	2.1	5.1	7.5	4.9	4.8	3.0	1.8	3.8	10.4	6.6	4.4
Government Purchases	2.5	25.9	-15.6	-4.1	6.9	15.8	-14.1	-0.1	4.4	10.9	2.8	2.6	0.6
Final Sales	8.3	4.0	4.6	7.0	7.8	8.1	6.9	7.4	7.8	4.2	2.6	5.9	7.5
Change in Business Inventories (82$B)	0.3	-24.1	15.0	19.6	17.6	20.7	33.7	35.0	26.3	9.0	7.6	18.2	29.2
Industrial Production	1.9	3.2	4.7	5.9	6.1	6.5	4.5	3.4	2.4	2.6	0.5	4.1	4.6
New Car Sales (mill.)	13.2	11.5	10.8	11.5	11.9	11.6	11.6	11.6	11.7	11.2	11.6	11.5	11.6
Domestic Car Sales (mill.)	9.7	7.9	7.3	8.0	8.6	8.4	8.5	8.6	8.7	8.2	8.4	8.6	
New Housing Starts (mill.)	1.91	1.75	1.65	1.63	1.63	1.68	1.69	1.66	1.69	1.74	18.2	1.66	1.69
EMPLOYMENT, WAGES & PRICES													
Civilian Unemployment Rate (%)	6.9	6.8	6.8	6.7	6.5	6.2	6.0	5.8	5.6	7.2	7.0	6.5	5.7
Compensation	2.5	3.1	3.7	3.9	4.1	4.4	5.0	5.0	5.2	4.0	3.0	3.5	4.8
Productivity	0.4	0.0	1.8	2.0	1.7	1.7	1.2	0.9	0.8	0.5	0.9	1.2	1.3
Unit Labor Costs	2.2	2.7	2.1	1.9	2.4	2.7	3.8	4.1	4.3	3.7	2.1	2.3	3.4
Consumer Price Index	2.6	2.5	4.3	4.2	4.4	5.1	4.8	4.9	4.7	3.5	1.9	3.4	4.8
Implicit GNP Deflator	3.6	0.7	3.5	3.6	3.2	3.8	4.2	4.2	4.2	3.3	2.6	2.9	4.0
Prime Interest Rate (%)	7.9	7.5	7.4	7.1	6.9	7.0	7.4	7.5	7.8	9.9	8.3	7.1	7.7
3-mos. Treasury Bill Rate (%)	5.5	5.3	5.2	4.9	4.8	4.9	5.0	5.2	5.4	7.5	6.0	4.9	5.3
Corporate Bond Rate (%)	8.8	8.7	8.4	8.2	8.0	7.9	8.0	8.0	7.9	11.4	9.0	8.1	8.0
Real Personal Disposable Income	-3.3	-0.3	4.6	1.3	1.7	1.4	6.5	1.3	1.4	1.4	3.0	1.6	2.7
Profits from Current Production ($B)[1]	197.5	196.2	177.2	182.3	188.4	196.8	206.2	209.1	209.5	189.0	197.2	186.2	208.5
GOVERNMENT FISCAL POLICY ($B)[2]													
Unified Receipts										736	769	836	910
Unified Outlays										937	990	1008	1069
Unified Deficit										-201	-221	-172	-159

[1]After-tax corporate profits with inventory valuation and capital consumption adjustments.
[2]Unified budget figures on a fiscal year basis. FY85 and FY86 data are actual.

SOURCE: U.S. Chamber of Commerce, Forecasting Section, using the Washington University model of the U.S. economy.

FORECAST ASSUMPTIONS

This month's forecast contains preliminary estimates of the National Income and Product Accounts for the fourth quarter of 1986. The forecast incorporates provisions of the recently enacted tax reform plan. The nation's money supply M(1) is assumed to grow by 10.8 percent during 1987 and 6.9 percent in 1988. The trade weighted exchange value of the dollar falls by 9.8 percent in 1987 and 1.0 percent in 1988. The federal minimum wage is not expected to increase.

enues have remained a relatively constant share of the national output. Revenues now account for 19.6% of GNP, compared to a 22-year average of 19.4%. However, beginning in the mid-1970s, we lost control of government spending, and its share of the national output began to rise significantly. Federal spending now stands at 24.5% of GNP compared to an average of 21.5%. The increase in the ratio of federal outlays to GNP reflects the fact that federal expenditures have been rising faster than GNP, while the resulting deficit reflects the fact that, with the exception of 1983, expenditures are rising faster than receipts. These data point clearly to the source of the deficit: excessive spending, and suggest that the cure should be a reduction in spending, not an increase in taxes.

Uncertainties Surrounding the Trade Picture

Although we anticipate a turnaround in the trade figures during the next two years, we believe that lack of improvement in this area is an important threat to the economy. One major problem is that economic growth in all our major trading partners is not expected to be higher than about 3% this year and next. However, our export sector faces other more pressing problems than a weak foreign demand. The lack of competitiveness of U.S. products is widely recognized. Unfortunately, however, while the buzzword in Washington these days is "international competitiveness," many of the tax policy changes that were made as part of the Tax Reform Act of 1986 will work to the detriment of our international competitiveness.

For example, the Tax Reform Act raised the capital gains tax rates. Through its impact on risk investment and the mobility of capital, higher capital gains tax rates will have a negative impact on innovation, technological advancement, and new business formation. American firms will find themselves at a disadvantage *vis-à-vis* competitors from Japan, West Germany, and South Korea, whose citizens are exempt from capital gains taxes. The Tax Reform Act repealed the Investment Tax Credit and reduced depreciation deductions, thus raising the cost of capital and increasing the tax bias against investment. Lower levels of investment mean lower productivity and higher costs for American products. The new corporate minimum tax treats a large portion of accelerated depreciation as a tax preference item. This effectively repeals the bulk of any economic development or international competitiveness benefits accruing to the U.S. economy as a result of the capital cost recovery system. The Act reduced the research and development tax credit rate from 25% to 20% and failed to make it permanent. And its separate foreign tax credit limitation and allocation provisions will raise taxes on the worldwide operations of U.S. firms, thus offsetting the effect of the lower corporate tax rate.

The Protectionist Threat

Protectionist legislation represents another policy risk to the U.S. economy. Protectionism is not only the wrong solution to the trade deficit, it is a dangerous and irresponsible reaction to the problems of the export sector. Protectionism encourages retaliation and trade wars. Protectionism *vis-à-vis* the indebted developing countries will impair their ability to increase exports, raise foreign exchange and repay their debts, threatening the international financial system. Protectionism increases domestic costs of imported inputs and consumer goods, exacerbating inflationary pressures. Moreover, protectionism does not save American jobs. The jobs that might be preserved in the protected industry are offset by job losses elsewhere in the economy. The solution to the trade conundrum is (1) to encourage our industrialized trading partners to increase their own domestic demand; (2) to work to reduce nontariff trade barriers which unfairly keep U.S. products out of certain markets; and (3) enact legislation that will improve the competitiveness of U.S. exports.

The Potential for Increased Inflation

Despite the fact that wage pressures remain moderate, the risks of a resurgence in inflation have recently increased. Although the relationship between the rate of growth in the money supply and nominal GNP is not the same now as it was in the past, the rate of increase in M1 that we have recently experienced is alarming. Between the end of October and the end of December, M1 increased by 25.3%. Given the fact that nonoil import prices are rising steadily, and oil prices have also risen, the prognosis is for a reacceleration in inflation which could be further exacerbated by the enactment of protectionist legislation.

* * *

This recovery, which began with above-average strength, was debunked almost every step of the way. First, it was not supposed to happen. Once it was clear that the recovery was underway, we were told that it would not last long. And now, its impending death is reported frequently. Despite this cynicism, however, the economy has continued to move forward and, if the majority of the forecasting profession can be believed, it is on its way to achieving record longevity. Admittedly, everything is not coming up roses; some traditional industries have not recovered and are not likely to do so. Despite the impressive increases in employment, the unemployment rate is not as low as we would like it to be and interest rates could also be lower. These are causes for concern, but we should remember that what we have done in this decade, in sharp contrast to the previous one, is that we have added a sense of stability and certainty to the economy.

TABLE II
TRENDS IN COMMERCE

	Current Period		Previous Period	Year Ago	Percent Change From Previous Period	Percent Change From Year Ago
Population (Millions) [a]	Dec '86	242.5	242.4	239.3	[c]	1.3
Gross National Product ($B)	IV '86	4,260.6	4,240.7	4,087.7	0.5	4.2
Gross National Product (82$B)	IV '86	3,698.3	3,686.4	3,622.3	0.3	2.1
Money Supply (M1) ($B)	Dec '86	730.4	713.5	626.6	2.4	16.6
Money Supply (M2) ($B)	Dec '86	2,804.7	2,781.4	2,566.5	0.8	9.3
PEOPLE AND THEIR MONEY						
Personal Consumption Expenditures ($B)	Dec '86	2,863.8	2,806.5	2,705.0	2.0	5.9
Personal Consumption Expenditures (82$B)	Nov '86	2,432.7	2,423.8	2,377.1	0.4	2.3
Disposable Personal Income ($B)	Dec '86	3,019.1	2,993.6	2,913.4	0.9	3.6
Disposable Personal Income (82$)	Nov '86	2,594.9	2,598.7	2,560.3	-0.1	1.4
Personal Savings Rate (%)	Dec '86	1.8	2.9	4.1	-1.1[b]	-2.3[b]
Civilian Employment (millions)	Jan '87	111.0	110.6	109.0	0.4	1.9
Civilian Unemployment Rate (%)	Jan '87	6.7	6.7	6.8	0.0[b]	-0.1[b]
Average Hourly Earnings	Jan '87	$8.83	$8.82	$8.68	0.1	1.7
Consumer Price Index (All Urban, 67 = 100) [a]	Dec '86	331.1	330.8	327.4	0.2	1.1
Prime Interest Rate (%) Feb. 9, 1987	Feb '87	7.5	7.5	9.5	0.0[b]	-2.0[b]
Retail Sales ($B)	Jan '87	119.3	126.6	117.3	-5.8	1.7
SERVICES SECTOR						
Employment in Services (Millions)	Jan '87	76.7	76.4	74.2	0.4	3.4
Consumer Purchases of Service ($B)	Dec '86	1,483.0	1,480.3	1,406.0	0.2	5.5
Consumer Purchases of Service (82$B)	Nov '86	1,191.1	1,180.5	1,174.0	0.9	1.5
Domestic Revenue Passenger Mileage Flown Major Airlines (Billions) [a]	Nov '86	21.2	22.3	17.7	-4.9	19.8
BUSINESS PROFITS AND OUTPUT						
Corporate Profits and Cash Flow ($B)						
Before Tax	III '86	240.4	227.7	229.2	5.6	4.9
Profits Tax Liability	III '86	104.4	99.0	95.8	5.5	9.0
Tax Liability as a Percent of Profits	III '86	43.4	43.4	41.8	0.0[b]	1.6[b]
After Tax	III '86	135.9	128.8	133.4	5.4	1.9
Net Cash Flow	III '86	384.3	374.9	382.8	2.5	2.5
Industrial Production (77 = 100)	Jan '87	126.6	126.0	123.6	0.5	0.9
Capacity Utilization Rate (Mfg.) (%)	Dec '86	80.3	79.9	80.2	0.4[b]	0.1[b]
New Housing Starts (thou. units)	Jan '87	1,806.0	1,808.0	2,004.0	-0.1	-9.9
BUSINESS COSTS						
Unit Labor Costs (nonfarm) (77 = 100)	IV '86	172.7	170.7	169.3	1.2	2.0
Unit Nonlabor Costs (nonfarm) (77 = 100)	IV '86	162.1	165.9	160.3	-2.3	1.1
Producer Price Indices (67 = 100) [d]						
Crude Materials	Jan '87	284.0	274.8	302.9	3.3	-6.2
Intermediate Goods	Jan '87	307.1	305.0	313.8	[c]	-2.1
Finished Goods	Jan '87	291.7	289.9	291.3	0.6	0.1
INTERNATIONAL TRADE						
Exports of Goods & Services ($B)	IV '86	380.7	370.8	368.2	2.7	3.4
Imports of Goods & Services ($B)	IV '86	494.3	479.7	473.6	3.0	4.4
Balance on Goods & Services ($B)	IV '86	-113.6	-108.9	-105.3	4.3	7.9
WHAT'S AHEAD?						
Index of Leading Indicators (67 = 100) [a]	Dec '86	186.1	182.2	173.6	2.1	7.2

NOTE: All data seasonally adjusted unless otherwise noted

[a] Not seasonally adjusted
[b] Percentage point difference
[c] Less than 0.1 percent
[d] Index number not seasonally adjusted, percent change seasonally adjusted

8/10/87 A3840-6

ECONOMIC OUTLOOK

Chamber of Commerce of the United States

May/June 1987

NO SIGNIFICANT CHANGE IN THE OUTLOOK DESPITE FIRST QUARTER NUMBERS

Nineteen eighty-seven began with a bang, but it was a bang without much fireworks. The impressive 4.3 percent increase in first quarter real GNP was the strongest quarterly growth rate since the second quarter of 1984. Unfortunately, despite the strength, the first quarter number is not one to feel particularly encouraged about. The 4.3 percent surge was largely due to an almost $60 billion swing in real business inventories which, given a 2.2 percent decline in real final sales, can be assumed to be almost entirely unintended. The inventory swing contributed 6.6 percentage points to the increase in real GNP. (A large portion of the rise in inventories was accounted for by a $20.8 billion swing in government surplus commodity purchases. But adjusting for this, the increase in inventories was still substantial, accounting for the entire increase in real GNP.) The only other positive contributor to the nation's output of goods and services was a sharp increase in real net exports; every other component – consumer spending, business fixed investment, residential investment – posted quarterly declines, some of which were quite substantial.

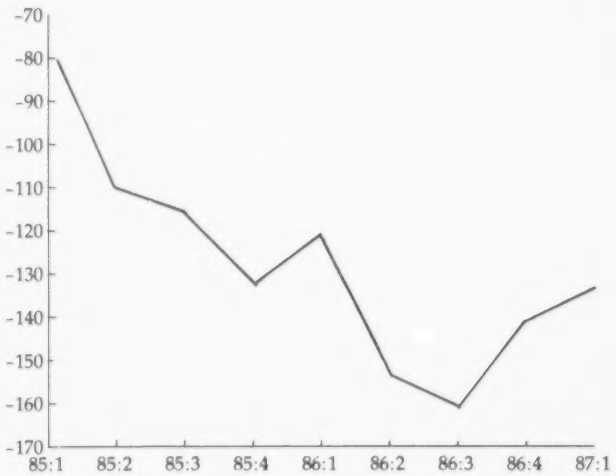
The sharp increase in inventory accumulation in the face of declines in final sales does not bode well for the second quarter. Unless domestic demand picks up significantly, anticipated inventory changes will make a negative contribution to GNP in the second quarter. For example, we expect an $18 billion increase in real business inventories; however, the swing in inventories, from $31 billion in the first quarter to the projected $18 billion in the second, makes a $13 billion negative contribution to GNP.

The news on the trade front is mixed. Both exports and imports fell during the first three months of this year, but imports fell a lot faster than exports, resulting in a narrowing of the trade deficit. This is not a pattern that we would like to see continued (i.e., we would rather see the trade gap narrow due to faster export growth), in spite of the fact that it would yield declines in the net trade deficit, because declines in trade flows are indicative of weakness in the world economy. But while concern about the nominal merchandise trade gap continues, the trade deficit on both goods and services adjusted for inflation (that is, real net exports), appears to have peaked in the third quarter of last year and shows a $29 billion improvement since then. This improvement is made up of a 3.5 percent increase in exports and a 3 percent decline in imports. This is the good news; real net exports made significant contributions to real GNP growth during the last two quarters.

CHART 1

REAL NET EXPORTS ARE IMPROVING

(BILLIONS 82$)



Unfortunately, legislators have concentrated their attention on the merchandise trade deficit, failing to appreciate

Dr. Richard W. Rahn, Vice President and Chief Economist.
Ms. Graciela Testa-Ortiz, Director, Forecast Section.

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TABLE I
UNITED STATES ECONOMIC OUTLOOK 1987-1989
Prepared by the U.S. Chamber of Commerce
(Percent change from previous period at seasonally adjusted annual rates.)

	QUARTERS									YEARS			
	Actual		Forecast							Actual	Forecast		
	86:4	87:1	87:2	87:3	87:4	88:1	88:2	88:3	88:4	1986	1987	1988	1989
GROSS NATIONAL PRODUCT													
Real GNP	1.1	4.3	2.0	2.2	3.8	4.4	4.4	3.6	4.2	2.5	2.5	3.7	3.3
Consumption	-0.4	-0.4	3.6	2.7	1.2	2.7	2.9	2.6	3.0	4.1	2.1	2.5	2.9
Residential Investment	5.2	-7.2	4.1	-2.3	1.2	4.4	4.8	0.7	5.8	9.4	1.6	2.6	3.0
Nonresidential Investment	3.0	-12.8	3.2	4.6	3.8	9.1	8.6	7.4	4.5	-1.0	-1.8	6.6	5.5
Equipment	6.6	-9.6	5.3	6.7	5.5	9.0	9.0	7.9	4.6	4.2	2.1	7.4	5.8
Structures	-5.4	-21.0	-1.9	-0.8	-0.8	9.3	7.4	5.9	4.1	-11.6	-11.0	4.3	4.5
Exports	16.7	-1.6	8.3	9.0	9.6	12.8	13.3	11.1	10.0	2.5	6.7	11.2	8.0
Real Net Exports (82$B)	-148.0	-134.2	-132.2	-127.4	-122.0	-115.1	-109.7	-106.0	-100.9	-147.8	-128.9	-107.9	-94.6
Imports	-0.5	-11.1	4.4	2.9	3.0	4.3	6.2	5.9	4.2	10.4	1.2	4.4	4.0
Government Purchases	23.2	-17.4	1.4	5.0	12.5	-12.6	2.6	4.4	11.5	2.7	1.7	1.2	0.4
Final Sales	3.9	1.9	7.4	7.0	6.9	7.0	8.2	7.9	9.0	5.3	5.3	7.5	7.9
Change in Business Inventories (82$B)	-28.5	31.0	18.0	7.2	12.7	26.5	28.1	27.3	23.5	6.6	17.2	26.3	28.2
Industrial Production	3.3	2.5	2.6	2.9	5.9	6.3	6.5	4.7	6.1	0.5	2.5	5.4	3.9
New Car Sales (mill.)	11.5	9.4	10.0	10.2	10.5	11.2	11.6	11.5	11.8	11.6	10.6	11.9	11.2
Domestic Car Sales (mill.)	7.9	6.8	7.1	7.3	7.5	8.0	8.3	8.3	8.5	8.4	7.2	8.3	8.0
New Housing Starts (mill.)	1.70	1.81	1.72	1.72	1.70	1.79	1.79	1.80	1.87	1.82	1.74	1.81	1.82
EMPLOYMENT, WAGES & PRICES													
Civilian Unemployment Rate (%)	6.8	6.7	6.4	6.5	6.4	6.2	6.1	6.0	5.9	7.0	6.5	6.1	5.9
Compensation	2.7	2.9	3.7	4.1	4.2	4.7	4.6	4.8	4.9	3.0	3.1	4.5	5.1
Productivity	-2.2	1.9	0.3	0.8	2.1	2.0	1.7	1.0	1.5	0.7	0.4	1.6	1.2
Unit Labor Costs	5.5	0.5	3.5	3.2	2.0	2.6	2.9	3.7	3.4	2.3	2.8	2.9	3.9
Consumer Price Index	2.9	5.3	4.6	4.6	4.4	4.4	4.6	4.8	4.9	1.9	3.8	4.6	4.8
Implicit GNP Deflator	0.7	3.5	3.8	3.6	3.4	3.8	3.7	4.1	4.2	2.6	2.9	3.8	4.5
Prime Interest Rate (%)	7.5	7.5	8.0	8.0	8.0	8.1	8.1	8.2	8.1	8.3	7.9	8.1	8.0
3-mos. Treasury Bill Rate (%)	5.4	5.5	5.7	5.7	5.8	5.8	5.8	5.7	5.8	6.0	5.7	5.8	5.8
Corporate Bond Rate (%)	8.7	8.4	8.9	9.0	9.0	9.1	9.2	9.0	8.9	9.0	9.2	9.1	8.9
Real Personal Disposable Income	-1.4	4.0	0.3	1.0	1.4	4.6	1.7	1.7	2.2	2.9	1.0	2.2	2.4
Profits from Current Production ($B)[1]	196.1	217.6	196.7	192.9	196.7	211.9	217.1	220.1	223.3	197.1	201.0	218.0	229.7
GOVERNMENT FISCAL POLICY ($B)[2]													
Unified Receipts										769	836	910	972
Unified Outlays										990	1008	1069	1135
Unified Deficit										-221	-172	-159	-163

[1]After-tax corporate profits with inventory valuation and capital consumption adjustments.
[2]Unified budget figures on a fiscal year basis. FY86 data are actual.

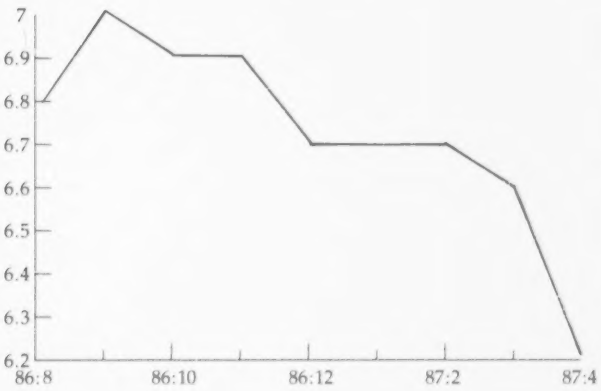
SOURCE: U.S. Chamber of Commerce, Forecasting Section, using the Washington University model of the U.S. economy.

FORECAST ASSUMPTIONS

This month's forecast contains preliminary estimates of the National Income and Product Accounts for the first quarter of 1987. The forecast incorporates provisions of the recently enacted tax reform plan. The nation's money supply M(1) is assumed to grow by 8.2 percent during 1987, 7.9 percent in 1988 and 7.3 percent in 1989. The trade weighted exchange value of the dollar falls by 12.3 percent in 1987, 1.0 percent in 1988 and stabilizes in 1989. The federal minimum wage is not expected to increase.

the improvement in real net exports during the past six months, and seemingly intent on following the protectionist path to global ruin, or at least stagnation. As we have pointed out in the past, the evidence of a turnaround in exports already exists. The decline in the value of the dollar has improved the competitiveness of American exports. One telling bit of evidence comes from an industry which has been battered by imports—steel. USX has just reported a shipment of steel to Japan, and the company's chairman has been quoted as saying that "the nation's steel industry is now in a good position to increase export shipments." However, we cannot expect a significant resurgence in U.S. exports as long as the world economy remains stagnant, and on that front, the news is far from encouraging.

CHART 2
CIVILIAN UNEMPLOYMENT PLUNGED IN APRIL
(PERCENT)



Given the weakness in demand from our major trading partners—Japan, Western Europe and Latin America—we are not likely to see a dramatic turnaround in export growth this year. Although a continuation of the improvement that we have been experiencing since mid-1986 can be expected.

* * *

Consumer spending should show an improvement following two quarters of decline; however, the increase for the year as a whole is expected to be only 2.1 percent compared to a 4.1 percent rate of increase during 1986. The onset of spring has evidently been accompanied by an improvement in consumer sentiment. The Conference Board reports that its consumer confidence index reached its highest level in 15 months in March, and despite a falloff in April, remains at a level that has historically been associated with reasonable growth rates in spending. Personal income increased quite substantially during the first quarter, showing a 4 percent gain on an after-tax, inflation-adjusted basis. This gain reflects improvements in employment as shown by continued declines in the unemployment rate, which fell to 6.3 percent in April. Indeed, labor demand may be picking up after a prolonged period of stagnation. The March index of help-wanted advertising reached a seven-year high.

The housing sector presents a mixed picture and may be the source of weakness in coming months. First quarter figures show a 100,000 unit rise in new housing starts, yet the GNP data show a 7.2 percent decline in residential investment. That weakness, however, was heavily concentrated in the "additions and alternations" component of residential construction. Yet the sharp rise in mortgage rates of the past few weeks is likely to take its toll on the housing market. We expect that housing starts will fall back to a level consistent with demographic and replacement demand, that is, about 1.7 million units per year. However, such a projection assumes that mortgage rates do not keep rising. In the coming months, we may well see a significant overreaction to the current spike in mortgage rates.

Reflecting the changes in the tax law which reduced certain investment incentives, business fixed investment fell sharply in the first quarter, led by a 21 percent drop in investment in nonresidential structures. Yet there is some evidence of improvement. New orders of manufactured goods rose by 3.4 percent in March, following a 6.7 percent advance in February. Admittedly, the gains followed a 9.8 percent tumble in January, but after the erratic swings of December and January are averaged out, it is apparent that nonmilitary orders have been accelerating, rising by 2.9 percent during the first quarter. Moreover, the National Association of Purchasing Managers survey shows that industrial activity picked up a bit more in April. The forecast calls for an improvement in the durable equipment component of investment for the remainder of this year, yet continued declines in nonresidential structures means that the business investment sector will post a 1.6 percent decline this year, following a 1 percent falloff in 1986. Investment in nonresidential structures is not expected to rise during 1987 as the sector is negatively affected by both the less generous treatment of depreciation embodied in the new tax code and the continuing adjustment to high vacancy rates in commercial and office buildings.

Prospects for 1988 are significantly better since the final phase of the personal and corporate tax rate reduction will go into effect in January. Yet the strength of the economy next year depends significantly upon three factors: (1) that the tax cut will be implemented as expected, (2) that interest rates do not rise further, and (3) that export growth strengthens significantly. While the risks appear to be on the downside, we expect 1988 to be better than this one.

TABLE II
TRENDS IN COMMERCE

	Current Period		Previous Period	Year Ago	Percent Change From Previous Period	Percent Change From Year Ago
Population (millions) [a]	Mar/87	243.0	242.9	240.9	[c]	0.9
Gross National Product ($B)	I/87	4,339.2	4,258.7	4,149.2	1.9	4.6
Gross National Product (82$B)	I/87	3,735.2	3,696.1	3,655.9	1.1	2.2
Money Supply (M1) ($B)	Mar/87	739.2	737.2	640.5	0.3	15.4
Money Supply (M2) ($B)	Mar/87	2,825.6	2,821.5	2,598.9	0.1	8.7
PEOPLE AND THEIR MONEY						
Personal Consumption Expenditures ($B)	Mar/87	2,882.6	2,873.7	2,705.9	0.3	6.5
Personal Consumption Expenditures (82$B)	Feb/87	2,460.0	2,408.9	2,377.5	2.1	3.5
Disposable Personal Income ($B)	Mar/87	3,086.9	3,075.4	2,947.8	0.3	4.7
Disposable Personal Income (82$)	Feb/87	2,632.6	2,593.3	2,583.0	1.5	1.9
Personal Savings Rate (%)	Mar/87	3.4	3.4	5.4	0.0[b]	−2.0[b]
Civilian Employment (millions)	Apr/87	111.8	111.4	109.0	0.4	2.6
Civilian Unemployment Rate (%)	Apr/87	6.3	6.6	7.1	−0.3[b]	−0.8[b]
Average Hourly Earnings	Apr/87	$8.88	$8.90	$8.72	-0.2	1.8
Consumer Price Index (All Urban, 67 = 100) [a]	Mar/87	335.9	334.4	326.0	0.3	3.0
Prime Interest Rate (%) May 5, 1987	May/87	8.0	7.5	8.5	0.5[b]	−0.5[b]
Retail Sales ($B)	Apr/87	125.4	125.2	118.4	0.1	5.9
SERVICES SECTOR						
Employment in Services (millions)	Apr/87	77.3	77.0	74.7	0.4	3.5
Consumer Purchases of Service ($B)	Mar/87	1,513.9	1,509.3	1,417.8	0.3	6.8
Consumer Purchases of Service (82$B)	Feb/87	1,205.8	1,197.9	1,168.8	0.7	3.2
Domestic Revenue Passenger Mileage Flown						
Major Airlines (billions) [a]	Mar/87	28.8	23.2	25.5	24.1	12.9
BUSINESS PROFITS AND OUTPUT						
Corporate Profits and Cash Flow ($B)						
Before Tax	IV/86	259.6	240.4	235.8	8.0	10.1
Profits Tax Liability	IV/86	115.1	104.4	96.4	10.2	19.4
Tax Liability as a Percent of Profits	IV/86	44.3	43.4	40.9	0.9[b]	3.4[b]
After Tax	IV/86	144.5	135.9	139.4	6.3	3.7
Net Cash Flow	IV/86	399.2	384.3	389.4	3.9	2.5
Industrial Production (77 = 100)	Mar/87	126.7	127.1	123.6	−0.3	2.5
Capacity Utilization Rate (Mfg.) (%)	Mar/87	79.2	79.7	79.0	−0.5[b]	0.2[b]
New Housing Starts (thou. units)	Mar/87	1,774.0	1,833.0	1,887.0	−3.2	−6.0
BUSINESS COSTS						
Unit Labor Costs (nonfarm) (77 = 100)	I/87	171.8	172.5	165.9	0.1	1.4
Unit Nonlabor Costs (nonfarm) (77 = 100)	I/87	167.2	162.2	163.9	3.1	2.0
Producer Price Indices (67 = 100) [d]						
Crude Materials	Mar/87	287.7	288.8	281.3	−0.2	−6.7
Intermediate Goods	Mar/87	309.4	308.9	309.5	0.1	[c]
Finished Goods	Mar/87	292.3	292.3	288.0	0.0	1.5
FEDERAL SPENDING AND DEBT						
Federal Spending Index (67 = 100)	Mar/87	640.3	654.5	611.2	−2.2	4.8
Fed. Gov't Gross Debt Outstanding ($B) [a]	Mar/87	2,250.7	2,245.1	1,991.1	0.2	13.0
INTERNATIONAL TRADE						
Exports of Goods & Services ($B)	I/87	384.2	385.8	369.2	−0.4	4.1
Imports of Goods & Services ($B)	I/87	518.4	533.8	495.1	−2.9	4.7
Balance on Goods & Services ($B)	I/87	−134.2	−148.0	−93.7	−9.3	43.2
WHAT'S AHEAD?						
Index of Leading Indicators (67 = 100) [a]	Mar/87	187.5	186.8	176.4	0.4	6.3

NOTE: All data seasonally adjusted unless otherwise noted

[a] Not seasonally adjusted
[b] Percentage point difference
[c] Less than 0.05 percent
[d] Index number not seasonally adjusted, percent change seasonally adjusted

7/30/87 A3840-6

ECONOMIC OUTLOOK

Chamber of Commerce of the United States July/August 1987

STEADY AS SHE GOES

The current economic environment is one of some uncertainty. Over the last year or more, the U.S. economy has grown slowly, as have those of the leading nations of the world. In one direction, we see emerging evidence to suggest that economic growth could slip even further. At the same time, we still see many signs which demonstrate surprising strength. Pushed and pulled in different directions, economic forecasts now vary widely, and economists change their minds with alarming frequency.

Although the economy has been muddling along for more than a year, over the past two quarters, key sectors of the economy have turned down, including personal consumption expenditures which had been an important source of strength. On top of this are a number of other emerging trends that should concern us. Chief among them is the sharp decline and volatility in the value of the dollar, growing inflationary pressures, and rising interest rates.

It is in the international trade area where, paradoxically, we find both cause for concern and cause for optimism. First the good news. The decline in the dollar—nearly 50% against the yen and 34% against all currencies on a trade-weighted basis—will lead to a swift reduction in the trade deficit. On a quantity basis, imports peaked last November and have since fallen by nearly 3%. At the same time, exports have been rising since last year.

By the end of this year, exports will have increased by about 12% while import growth could decelerate to 2.7% from 10% last year. While this reversal is already underway, the general perception is one of no progress because of the preoccupation with the merchandise trade figures. For those deeply concerned about our trade deficit, this will be viewed as good news. But as we consider the many ways in which this deficit could be reduced, it is essential that we do not let it become the tail that wags the dog.

Trade deficits are subject to any number of cures, some of which are very harmful. Solutions that emphasize increased productivity and innovation are preferred because they make us more competitive and increase our standard of living by providing greater quality at lower cost. Currency depreciation will work in the short run, but must be supported by productivity-enhancing measures if the cure is to be permanent. Erecting barriers to trade is obviously the worst alternative. It solves the problem by simply reducing the number of competitors. Perhaps because of impatience, our government rejected a productivity-enhancing strategy and seems to have settled, at least for the moment, on currency depreciation as the only politically acceptable way to resolve the problem. Avoiding the third choice—protectionism and retaliation—is now the challenge that confronts Congress.

We are already beginning to experience some of the costs associated with the new exchange rate policy. Producer and consumer price indices have increased in recent months, partly as a result of the higher import prices. And as imports are reduced, economic growth abroad will slow which, in turn, could hurt our exports. In recent months, growth has slowed in Germany, Britain, and Canada, three of our major trading partners.

The impact on prices is not the only problem associated with a declining dollar. Trade in products and services is but a part of the commercial relations between nations. Just as important are the many financial and investment transactions that occur when investors abroad buy our financial or tangible assets, and vice versa. Any change in exchange rates will also induce changes in the capital account, which, in some circumstances, could create other problems for the domestic economy.

Dr. Richard W. Rahn, Vice President and Chief Economist.
Ms. Graciela Testa-Ortiz, Director, Forecast Section.

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TABLE I
UNITED STATES ECONOMIC OUTLOOK 1987–1989
Prepared by the U.S. Chamber of Commerce
(Percent change from previous period at seasonally adjusted annual rates.)

	QUARTERS									YEARS			
	Actual		Forecast							Actual	Forecast		
	86:4	87:1	87:2	87:3	87:4	88:1	88:2	88:3	88:4	1986	1987	1988	1989
GROSS NATIONAL PRODUCT													
Real GNP	1.1	4.8	1.4	2.9	4.0	4.0	3.4	3.5	3.3	2.5	2.6	3.5	2.5
Consumption	-0.4	-1.1	2.7	2.8	1.8	1.2	2.0	2.8	2.1	4.1	1.8	2.0	2.3
Residential Investment	5.2	-4.7	-1.5	-6.3	-1.2	-0.2	6.5	6.8	6.8	9.4	0.5	1.2	2.8
Nonresidential Investment	3.0	-9.7	4.6	4.5	2.8	6.9	5.6	5.6	3.5	-1.0	-0.7	5.1	2.8
Equipment	6.6	-9.2	8.0	7.5	4.5	7.0	5.4	5.6	3.8	4.2	2.7	6.0	2.8
Structures	-5.4	-10.5	-4.1	-3.1	-1.7	6.4	6.1	5.8	2.7	-11.6	-8.9	2.6	2.9
Exports	16.7	11.8	12.3	14.6	15.5	16.4	13.6	10.3	8.7	2.5	12.1	13.9	8.1
Real Net Exports (82$B)	-148.0	-133.7	-120.6	-110.6	-101.6	-91.7	-85.2	-81.1	-77.2	-147.8	-116.6	-83.8	-64.5
Imports	-0.5	-2.6	-1.0	3.2	4.9	5.4	6.1	5.6	4.6	10.4	2.7	4.7	3.4
Government Purchases	23.2	-24.2	8.2	4.1	12.2	-12.8	1.8	3.9	11.0	2.7	0.6	1.2	0.0
Final Sales	3.9	2.1	8.7	7.6	7.6	6.4	7.9	8.5	8.5	5.3	5.7	7.6	7.6
Change in Business Inventories (82$B)	-28.5	40.7	9.7	2.7	6.9	28.8	29.5	27.1	23.5	6.6	15.0	27.2	21.9
Industrial Production	3.3	3.2	4.1	3.4	6.2	5.9	4.8	4.7	4.6	0.5	3.1	5.1	2.8
New Car Sales (mill.)	11.5	9.4	9.7	10.0	10.1	10.6	11.1	11.5	11.6	11.6	9.8	11.2	10.9
Domestic Car Sales (mill.)	7.9	6.8	7.0	7.2	7.2	7.6	8.1	8.3	8.4	8.4	7.1	8.1	8.0
New Housing Starts (mill.)	1.70	1.79	1.64	1.64	1.62	1.66	1.74	1.76	1.82	1.82	1.67	1.75	1.72
EMPLOYMENT, WAGES & PRICES													
Civilian Unemployment Rate (%)	6.8	6.7	6.2	6.2	6.1	6.0	5.7	5.5	5.3	7.0	6.3	5.6	5.1
Compensation	2.7	0.0	2.7	3.2	3.6	4.6	4.8	5.0	5.2	3.0	2.1	4.2	5.3
Productivity	-1.5	0.4	0.0	0.8	1.7	1.3	0.8	1.0	0.9	0.7	0.1	1.1	0.7
Unit Labor Costs	4.4	-0.5	2.9	2.3	1.9	3.2	4.0	4.0	4.2	2.2	2.0	3.1	4.6
Consumer Price Index	2.9	5.3	5.1	5.0	4.7	5.7	5.1	5.3	5.3	1.9	4.0	5.2	5.1
Implicit GNP Deflator	0.7	4.2	3.9	3.9	3.8	4.3	4.4	4.6	4.6	2.6	3.2	4.2	4.8
Prime Interest Rate (%)	7.5	7.5	8.0	8.3	8.3	8.2	8.2	8.1	8.0	8.3	8.0	8.1	8.0
3-mos. Treasury Bill Rate (%)	5.4	5.5	5.7	5.7	5.6	5.6	5.5	5.4	5.4	6.0	5.6	5.5	5.5
Corporate Bond Rate (%)	8.7	8.4	9.2	9.0	8.7	8.6	8.5	8.5	8.5	9.0	8.8	8.5	8.7
Real Personal Disposable Income	-1.4	2.7	-4.8	5.1	1.7	1.8	1.7	3.7	2.0	2.9	0.2	2.0	2.3
Profits from Current Production ($B)[1]	196.1	206.6	202.9	210.0	219.5	222.1	226.0	228.5	227.9	197.1	209.7	227.4	216.2
GOVERNMENT FISCAL POLICY ($B)[2]													
Unified Receipts										769	841	912	972
Unified Outlays										990	1008	1080	1145
Unified Deficit										-221	-167	-168	-173

[1]After-tax corporate profits with inventory valuation and capital consumption adjustments.
[2]Unified budget figures on a fiscal year basis. FY86 data are actual.

SOURCE: U.S. Chamber of Commerce, Forecasting Section, using the Washington University model of the U.S. economy.

FORECAST ASSUMPTIONS

This month's forecast contains estimates of the National Income and Product Accounts for the first quarter of 1987. The forecast incorporates provisions of the recently enacted tax reform plan. The nation's money supply M(1) is assumed to grow by 8.2 percent during 1987, 7.9 percent in 1988 and 7.3 percent in 1989. The trade weighted exchange value of the dollar falls by 12.3 percent in 1987, 1.0 percent in 1988 and stabilizes in 1989. The federal minimum wage is not expected to increase.

As the dollar declines, many foreign investments in the U.S. have declined in value when expressed in home country currencies. Some Japanese and German investors have suffered up to a 50% reduction in the value of their U.S. holdings in terms of yen or marks, and the Taiwan Central Bank is reported to have lost $6 billion so far. If the dollar is expected to fall further, then foreign investors will hold dollar assets only if they receive a risk premium in the form of higher interest rates.

A few weeks ago it looked as if such fears would become self-fulfilling. If worried foreign investors withdrew or withheld funds, then the dollar's value would fall further and capital markets would be disrupted. Apparently, it was this fear that induced the Fed to step in and firm up the dollar with tighter monetary policy. In response, interest rates rose across the whole spectrum. Over the first half of this year, monetary growth has been very erratic, growing at annual rates of more than 40% in late 1986, and then turning negative in early 1987. Longer term corporate bonds are up almost a full percentage point, while residential mortgage rates have risen even more. With investment already weak and the economy fairly sluggish, the higher interest rates call into question expectations of sluggish growth in 1987. Yet fears that the outcome would be worse—and that there would be a recession—appear to have abated now that financial markets have stabilized and the dollar has firmed.

Although a stabilized foreign exchange market would allow the Fed to ease up, the possibility of renewed inflationary pressures provide another reason why it is likely to remain restrictive for the foreseeable future. Consumer prices, which rose by just 1.9% last year, jumped to 5.3% during the first quarter and averaged 5% during the past six months.

While the problems are numerous, they are also resolvable. There are positive steps we could take to restore higher growth. Behind the decline in consumer spending is an increase in savings and debt repayment. This will lead to a reliquification of the consumer sector and establish a strong base from which the next expansion can be launched. For much of the last several years, spending growth has outpaced income and a decline in the savings rate made up the difference. This can only go on for so long, and it looks as if the consumer called it quits last year. Recently, almost half the increase in personal income has been saved. This is a healthy sign; and while it will lead to some short-term sluggishness, in the end it will contribute to a strong rebound in 1988.

Making the transition all the more stable are the continuing gains in employment that have occurred in recent months. In June, the civilian unemployment rate fell to 6.1%, its lowest level since December 1979. The full implementation of tax reform in 1988 will also serve to give the economy a boost. The adverse impacts of the loss of preference items in the old code will have worked themselves out and set the stage for an upturn when the full rate reductions are made effective.

What we have then, is something akin to a transition year in which a mature expansion begins to adjust to new rules and realities. By 1988, we expect the consumer to be in much better shape financially. The worst of tax reform will be behind us and the lower rates and new opportunities will begin to manifest themselves. And finally, the trade situation will have stabilized and will no longer be a drag on the overall economy. As a consequence, 1988 economic growth should take off from the somewhat depressed state that will likely characterize this year.

Achieving this take off will require that our government avoid doing silly things that may disrupt the natural process of consolidation that is now underway. With growth near 2%, there is little margin for error. Although we cannot expect much in the way of positive steps—what with the composition of Congress and the proximity to the next elections—it is essential that Congress avoid doing something counterproductive, like raising taxes (which are already up to uncomfortably high levels as a share of income), re-regulating important segments of the economy, or enacting a protectionist trade bill.

We are at risk in these areas, as the current budget deliberations demonstrate. Congress proposes that we raise taxes by $19 billion this year, just as it enacts an urgent supplemental spending bill that provides funds to establish a National Weed Center and an ad campaign to urge Americans to eat more fish, among many other such proposals. If we can avoid many more of these outcomes, we can muddle through the year until the positive factors come into full force in 1988—giving us the longest recovery of the postwar era.

REAL EXPORTS AND IMPORTS
(PERCENT CHANGE, YEAR AGO)

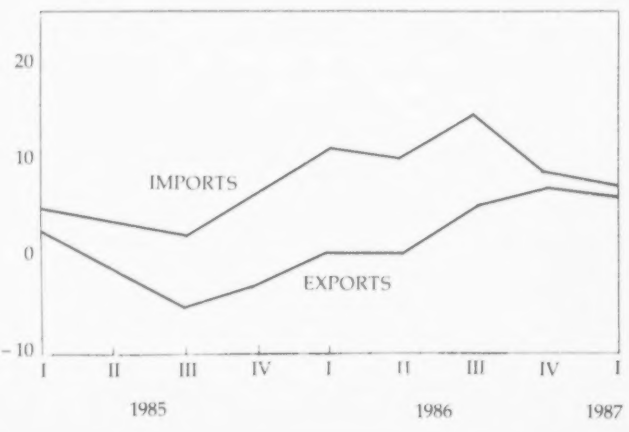

TABLE II
TRENDS IN COMMERCE

	Current Period		Previous Period	Year Ago	Percent Change From Previous Period	Percent Change From Year Ago
Population (millions) [a]	May/87	243.3	243.2	240.9	[c]	0.9
Gross National Product ($B)	I/87	4,352.1	4,258.7	4,149.2	2.1	4.9
Gross National Product (82$B)	I/87	3,739.4	3,696.1	3,655.9	1.2	2.3
Money Supply (M1) ($B)	May/87	739.2	737.2	640.5	0.3	15.4
Money Supply (M2) ($B)	May/87	2,825.6	2,821.5	2,598.9	0.1	8.7
PEOPLE AND THEIR MONEY						
Personal Consumption Expenditures ($B)	May/87	2,893.3	2,891.8	2,731.7	0.1	5.9
Personal Consumption Expenditures (82$B)	Apr/87	2,455.0	2,450.2	2,396.1	0.2	2.1
Disposable Personal Income ($B)	May/87	3,093.6	2,993.3	2,977.4	3.3	4.7
Disposable Personal Income (82$)	Apr/87	2,541.1	2,622.9	2,639.9	−3.1	1.9
Personal Savings Rate (%)	May/87	3.3	0.1	3.1	3.2[b]	0.2[b]
Civilian Employment (millions)	Jun/87	111.8	111.4	109.0	0.4	2.6
Civilian Unemployment Rate (%)	Jun/87	6.1	6.3	7.1	−0.3[b]	−0.8[b]
Average Hourly Earnings	Jun/87	$8.88	$8.90	$8.72	−0.2	1.8
Consumer Price Index (All Urban, 67 = 100) [a]	May/87	338.7	337.7	326.3	0.2	3.8
Prime Interest Rate (%) July 6, 1987		8.25	8.0	8.0	.25[b]	.25[b]
Retail Sales ($B)	May/87	124.0	124.8	119.6	−0.6	3.6
SERVICES SECTOR						
Employment in Services (millions)	Jun/87	77.0	76.9	74.7	0.1	3.0
Consumer Purchases of Service ($B)	May/87	1,532.9	1,526.7	1,426.1	0.4	7.5
Consumer Purchases of Service (82$B)	Apr/87	1,210.5	1,209.5	1,169.3	0.1	3.5
Domestic Revenue Passenger Mileage Flown						
Major Airlines (billions) [a]	May/87	27.4	27.7	24.5	−1.1	11.8
BUSINESS PROFITS AND OUTPUT						
Corporate Profits and Cash Flow ($B)						
Before Tax	I/87	267.6	259.6	222.5	3.0	20.3
Profits Tax Liability	I/87	128.8	115.1	95.7	11.9	34.5
Tax Liability as a Percent of Profits	I/87	48.1	44.3	43.0	3.8[b]	5.1[b]
After Tax	I/87	138.8	144.5	126.9	−3.9	9.3
Net Cash Flow	I/87	402.5	391.9	374.3	2.7	7.5
Industrial Production (77 = 100)	May/87	127.8	127.2	124.2	0.4	2.8
Capacity Utilization Rate (Mfg.) (%)	May/87	79.6	79.4	79.1	0.2[b]	0.6[b]
New Housing Starts (thou. units)	May/87	1,620.0	1,665.0	1,848.0	−2.7	−12.3
BUSINESS COSTS						
Unit Labor Costs (nonfarm) (77 = 100)	I/87	172.2	172.5	168.8	−0.1	2.0
Unit Nonlabor Costs (nonfarm) (77 = 100)	I/87	167.5	162.2	163.7	3.2	2.3
Producer Price Indices (67 = 100) [d]						
Crude Materials	May/87	304.7	295.5	279.4	3.1	9.1
Intermediate Goods	May/87	312.7	310.9	306.7	0.5	2.0
Finished Goods	May/87	296.3	295.0	288.9	0.4	2.6
FEDERAL SPENDING AND DEBT						
Federal Spending Index (67 = 100)	May/87	635.8	641.1	626.5	−0.8	1.5
Fed. Gov't Gross Debt Outstanding ($B) [a]	May/87	2,291.3	2,271.9	2,035.6	0.9	12.6
INTERNATIONAL TRADE						
Exports of Goods & Services ($B)	I/87	399.0	383.5	374.8	4.0	6.4
Imports of Goods & Services ($B)	I/87	506.9	493.7	468.5	2.6	8.1
Balance on Goods & Services ($B)	I/87	−107.9	−110.2	−93.7	−2.1	15.2
WHAT'S AHEAD?						
Index of Leading Indicators (67 = 100) [a]	May/87	189.3	187.9	178.5	0.7	6.0

NOTE: All data seasonally adjusted unless otherwise noted

[a] Not seasonally adjusted
[b] Percentage point difference
[c] Less than 0.05 percent
[d] Index number not seasonally adjusted, percent change seasonally adjusted

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E C O N O M I C
OUTLOOK

Chamber of Commerce of the United States September/October 1987

ECONOMIC EXPANSION MAKES HISTORY

The current economic expansion is unique by historic standards. As the economy enters its 59th month of recovery, all signs point to a continuation of healthy rates of economic growth--thus, virtually guaranteeing that the present recovery will become our longest peacetime expansion since 1796.

In addition to setting a longevity record, the current expansion has broken many others. Since November 1982, economic growth, on a yearly basis, has averaged 4.1%--the highest growth rate for any consecutive five-year period. But in contrast to other periods of rapid and sustained economic growth, inflation, rather than advancing, has actually been reduced--from an annual rate of 10.4% in 1981 to 1.9% in 1986. In addition, the reduction in marginal tax rates that brought the top rate from 70% in the 1970s to 28% in 1988, gives the U.S. the lowest income tax rate among industrial countries. This has created an economic environment conducive to investment growth and job creation.

Nearly fourteen million new jobs have been created since 1982, contributing to a record decline in the unemployment rate, which now stands at 6% compared to 9.5% in 1982. Other measures of improvements in the labor market are also evident: the civilian labor force participation rate rose to a record high of 65.3% in July, while the percentage of the adult population currently employed is at an all-time high of 61%.

As the number of job opportunities expanded, job quality also improved. There has been much speculation that a high proportion of the jobs created are low paying, low skill jobs. Yet, during the period 1981-85, 46.1% of the net new jobs created were in the high-wage category ($28,048 and over), while only 6% were in the low-wage category ($7,012) and under). In contrast, during the 1977-81 period, as much as 41.7% of the newly created jobs were in the low-wage category. As the share of high income jobs increased, so did median real family income. Over the last four years, median family income increased by 10.7%, the highest rise since the 1960s. Moreover, the increase in U.S. real per capita GDP has outstripped growth rates in the major industrial nations by a significant margin.

The data for July show that industrial production surged at a 9.7% rate, bringing the annual growth rate for the past three months to 7.8%. According to the National Association of Purchasing Management, the economy continued to grow vigorously in August. The buying agents' index rose to almost 60% in August, posting its 13th consecutive monthly increase and reaching its highest level since early 1984. And, after virtually no growth during the first nine months of 1986, manufacturing output has risen at a 4.8% annual rate. Output growth pushed the factory operating rate to 81% in August--the highest rate of capacity utilization in three years. More importantly, the index of leading indicators posted an impressive 0.5% increase in July, the sixth consecutive monthly increase.

Despite all the positive news, there are still those who doubt the economy's underlying strengths. At least one observer, Alfred Malabre of the *Wall Street Journal* contends that there is actually a recession under way. Looking at per capita disposable income, he points out that during the second quarter of this year, it fell by $149 from the first quarter, and is now at its lowest level since the first quarter of 1986. Is there really a recession under way? Is all the good news somehow masking a general decline in U.S. living standards?

Dr. Richard W. Rahn, Vice President and Chief Economist
Ms. Graciela Testa-Ortiz, Director, Forecast Section
Ms. Rajni Bonnie Ohri, Economist

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GROSS NATIONAL PRODUCT													
Real GNP	1.5	4.4	2.3	3.4	3.3	3.6	3.9	4.0	3.3	2.9	2.7	3.5	3.3
Consumption	0.5	-0.7	2.1	3.7	1.2	2.8	2.5	3.1	2.1	4.2	2.0	2.5	2.6
Residential Investment	2.2	-7.7	-2.2	-6.5	-0.3	1.6	1.8	1.1	2.8	12.5	-0.4	0.0	2.9
Nonresidential Investment	5.1	-14.6	9.3	6.6	1.0	8.7	6.4	7.5	8.4	-2.3	-1.5	6.4	5.7
Equipment	4.7	-15.3	12.7	8.0	0.9	9.8	7.2	8.5	9.2	2.9	0.7	7.4	6.4
Structures	6.3	-12.8	1.0	2.9	1.4	5.7	4.4	4.8	6.3	-12.8	-7.0	3.9	3.9
Exports	9.5	10.2	12.1	14.5	14.9	14.1	9.2	8.3	6.6	3.3	10.5	12.0	7.2
Real Net Exports (82$B)	-151.8	-135.2	-133.3	-123.9	-114.2	-106.7	-102.9	-99.6	-97.0	-145.8	-126.6	-101.6	-86.9
Imports	-0.8	-5.2	7.4	3.5	3.9	5.3	4.6	4.3	3.5	10.5	3.9	4.6	3.3
Government Purchases	15.2	-18.6	7.3	17.7	12.4	-11.8	2.2	4.7	11.5	2.5	2.6	3.2	0.7
Final Sales	3.0	3.0	7.7	8.8	7.1	6.1	7.7	8.6	8.6	5.5	5.6	7.5	8.1
Change in Business Inventories (82$B)	-14.4	47.6	37.8	17.5	17.9	25.2	30.5	30.8	23.7	13.8	30.2	27.6	31.4
Industrial Production	3.3	3.2	3.7	9.1	4.4	4.8	5.8	5.5	4.4	0.5	3.6	5.4	4.0
New Car Sales (mill.)	11.3	9.5	10.0	10.9	9.7	10.4	10.9	11.2	11.3	11.4	10.1	10.9	11.3
Domestic Car Sales (mill.)	7.8	6.7	7.0	7.9	6.7	7.4	7.9	8.2	8.3	8.2	7.1	7.9	8.3
New Housing Starts (mill.)	1.70	1.79	1.62	1.62	1.63	1.63	1.63	1.67	1.69	1.82	1.66	1.66	1.70
EMPLOYMENT, WAGES AND PRICES													
Civilian Unemployment Rate (%)	6.8	6.7	6.2	5.9	5.8	5.8	5.6	5.5	5.4	7.0	6.1	5.6	5.3
Compensation	4.0	1.1	2.9	3.9	4.0	4.5	4.6	5.0	5.3	3.9	2.8	4.3	5.3
Productivity	0.0	0.4	1.5	0.9	1.3	1.3	1.4	1.4	1.0	1.7	0.5	1.3	1.1
Unit Labor Costs	4.4	0.5	1.1	3.2	2.7	3.1	3.2	3.5	4.2	2.1	2.3	3.1	4.2
Consumer Price Index	2.7	5.3	4.9	4.1	4.0	4.2	4.7	5.1	5.1	1.9	3.7	4.5	5.0
Implicit GNP Deflator	0.7	4.2	3.8	3.2	3.7	3.0	4.1	4.5	4.5	2.6	3.2	3.7	4.8
Prime Interest Rate (%)	7.5	7.5	8.0	8.5	8.6	8.7	8.8	8.8	8.8	8.3	8.2	8.8	8.9
3-mos. Treasury Bill Rate (%)	5.4	5.5	5.6	6.1	6.2	6.3	6.4	6.5	6.5	6.0	5.9	6.4	6.6
Corporate Bond Rate (%)	8.7	8.4	9.2	9.5	9.5	9.5	9.4	9.4	9.3	9.0	9.1	9.4	9.2
Real Personal Disposable Income	0.6	2.5	-3.8	4.9	1.5	2.5	1.9	3.5	1.8	4.1	1.0	2.2	2.4
Profits from Current Production ($B)[1]	167.2	165.9	163.8	163.3	169.3	180.1	179.8	184.2	183.6	179.4	165.6	182.0	183.1
GOVERNMENT FISCAL POLICY ($B)[2]													
Unified Receipts										769	853	910	964
Unified Outlays										990	1010	1080	1145
Unified Deficit										-221	-157	-170	-181

[1]After-tax corporate profits with inventory valuation and capital consumption adjustments.

[2]Unified budget figures on a fiscal year basis. FY86 data are actual.

SOURCE: U.S. Chamber of Commerce, Forecasting Section, using the Washington University model of the U.S. economy.

FORECAST ASSUMPTIONS

This month's forecast contains preliminary estimates of the National Income and Product Accounts for the second quarter of 1987. The forecast incorporates provisions of the recently enacted tax reform plan. The nation's money supply M(1) is assumed to grow by 6.3 percent during 1987, 7.6 percent in 1988, and 8.3 percent in 1989. The trade weighted exchange value of the dollar falls by 9.1 percent in 1987, 5.3 percent in 1988, and stabilizes in 1989. The federal minimum wage is not assumed to increase.

Hardly. An examination of the data shows that the real reason for the decline in inflation-adjusted, after-tax income lies in the "policy mistakes" that we have warned, could undermine the economy's impressive performance. The truth is that the drop in real income is not a product of declining output, but of tax reform. By delaying the full implementation of the tax rate cuts until next year while making the loss in deductions effective in 1986, tax reform effectively *raised*, not lowered, taxes. Indeed, the second quarter shows one of the greatest assaults on individual income by the tax system in recent history. In fact, almost 82% of last quarter's increase in personal income went to personal tax payments.

Thus, as we continue to enjoy this unprecedented period of prosperity, we should remain well aware of the risks inherent in bad economic policy. A major risk, as Mr. Malabre has inadvertently shown, is that of tax increases. It is worth repeating: our nation's budget deficit is not the result of tax cuts, but of unrestrained spending. In fact, the total tax burden (including state and local taxes and payroll taxes as well as federal taxes), of Americans is now at levels similar to those of 1978, the year which saw the beginnings of the "Great American Tax Revolt." In addition, increases in social security taxes are already scheduled to go into effect in January 1988.

A resurgence in inflation is another major threat to our economic well-being. The Fed's recent increase in the discount rate was a necessary step to forestall another inflationary run-up. Higher oil prices were the dominant force pushing up producer and consumer price indices through the first half of 1987. But since oil prices have edged down recently, we should expect a near term slowdown in the rate of price increases. For the relatively longer term, inflationary pressures will intensify for the following reasons: prices of imported goods will continue to strengthen reflecting the decline in the dollar's value; labor shortages have become more widespread in recent months (help-wanted ads reached a high for the year in July), as this continues it will place upward pressure on wages; and the upward drift in capacity utilization could bring it closer to the point where bottlenecks and shortages begin to occur. Moreover, the scheduled increases in the social security tax base and rate, which will reduce American's take-home pay, will also boost compensation and business costs, and hence, push up prices. Reflecting this, our forecast anticipates a 3.7% increase in the consumer price index this year, followed by increases of 4.5% and 5% in 1988 and 1989, respectively.

In addition to the specters of rising inflation and taxes, the economy faces other policy risks, including protectionism, re-regulation of important segments of the economy, and increases in the minimum wage.

Our forecast anticipates a 2.7% increase in real GNP this year, followed by a 3.5% increase in 1988. Real net exports continue to be an important source of strength, despite the recent deterioration in the merchandise trade deficit. The merchandise trade deficit, of course, measures only trade in goods in nominal dollars, and usually undergoes significant revisions. Inflation-adjusted net exports of goods and services, however, have improved steadily since mid-1986, narrowing the trade gap by about $30 billion in the last four quarters. We expect that improvement to continue. The only relatively weak sector in the near future is expected to be housing which is bearing the brunt of the run-up in interest rates. Nevertheless, housing starts are not anticipated to fall below 1.6 million units.

PER CAPITA REAL GDP AND ITS GROWTH RATES IN THE G-5 COUNTRIES AT PPP EXCHANGE RATES*

($ 1982)

	Levels			Growth Rates		
	1974	1980	1986	1974-80	1980-86	1974-86
Canada	$12,513	$13,643	$13,712	1.45%	0.08%	0.77%
Germany	10,220	11,846	11,266	2.49	-0.83	0.82
Japan	8,052	9,820	10,655	3.36	1.37	2.36
United Kingdom	9,224	9,769	9,956	0.96	0.32	0.64
United States	12,326	13,356	15,022	1.35	1.98	1.66

*Purchasing power parity (PPP) is the estimated exchange rate at which the currencies of two different countries would purchase the same bundle of goods and services in either country.

Source: OECD estimates of nominal per capita GDP at PPP deflated by U.S. GNP deflator, The Federal Reserve Bank of St. Louis, *International Economic Conditions*, August 1987.

TABLE II
TRENDS IN COMMERCE

	Current Period		Previous Period	Year Ago	Percent Change From Previous Period	Percent Change From Year Ago
Population (millions) [a]	Jul/87	243.8	243.7	241.6	[c]	0.9
Gross National Product ($B)	II/87	4,444.7	4,377.7	4,211.6	1.5	5.5
Gross National Product (82$B)	II/87	3,793.7	3,772.2	3,704.7	0.6	2.4
Money Supply (M1) ($B)	Jul/87	747.6	746.6	676.6	0.1	10.5
Money Supply (M2) ($B)	Jul/87	2,846.2	2,840.2	2,693.8	0.2	5.7
PEOPLE AND THEIR MONEY						
Personal Consumption Expenditures ($B)	Jul/87	2,993.1	2,967.5	2,812.4	0.9	6.4
Personal Consumption Expenditures (82$B)	Jun/87	2,496.8	2,482.1	2,464.0	0.6	1.3
Disposable Personal Income ($B)	Jul/87	3,176.7	3,164.8	3,029.3	0.4	4.9
Disposable Personal Income (82$)	Jun/87	2,662.8	2,676.8	2,654.1	−0.5	0.3
Personal Savings Rate (%)	Jul/87	2.8	3.3	4.1	−0.5[b]	−1.3[b]
Civilian Employment (millions)	Aug/87	113.1	112.7	110.1	0.4	2.7
Civilian Unemployment Rate (%)	Aug/87	6.0	6.0	6.8	−0.0[b]	−0.8
Average Hourly Earnings	Aug/87	$9.03	$8.96	$8.77	0.8	3.0
Consumer Price Index (All Urban, 67 = 100) [a]	Jul/87	340.8	340.1	328.0	0.2	3.9
Prime Interest Rate (%) Sept 8, 1987	Sep/87	8.75	8.0	7.50	0.75[b]	1.25[b]
Retail Sales ($B)	Aug/87	128.6	126.9	121.8	1.3	5.6
SERVICES SECTOR						
Employment in Services (millions)	Aug/87	77.4	77.3	75.1	0.1	3.1
Consumer Purchases of Service ($B)	Jul/87	1,583.1	1,568.6	1,466.4	0.9	8.0
Consumer Purchases of Service (82$B)	Jun/87	1,230.8	1,222.6	1,194.4	0.7	3.0
Domestic Revenue Passenger Mileage Flown						
Major Airlines (billions) [a]	Jul/87	29.6	27.6	27.6	7.2	7.2
BUSINESS PROFITS AND OUTPUT						
Corporate Profits and Cash Flow ($B)						
Before Tax	II/87	267.1	257.0	224.4	3.9	19.0
Profits Tax Liability	II/87	132.7	128.0	102.1	3.7	30.0
Tax Liability as a Percent of Profits	II/87	49.7	49.8	45.5	−0.1[b]	4.2[b]
After Tax	II/87	134.4	129.0	122.3	4.7	9.9
Net Cash Flow	II/87	384.6	378.7	363.3	1.1	5.9
Industrial Production (77 = 100)	Aug/87	130.7	129.8	125.1	0.3	4.5
Capacity Utilization Rate (Mfg.) (%)	Jul/87	80.5	80.1	79.3	0.4[b]	1.2[b]
New Housing Starts (thou. units)	Jul/87	1,611.0	1,597.0	1,786.0	0.9	−9.8
BUSINESS COSTS						
Unit Labor Costs (nonfarm) (77 = 100)	II/87	172.6	171.8	168.4	0.5	2.5
Unit Nonlabor Costs (nonfarm) (77 = 100)	II/87	169.3	167.4	165.2	1.1	2.5
Producer Price Indices (67 = 100)						
Crude Materials	Aug/87	307.7	307.8	276.3	0.4[d]	11.4
Intermediate Goods	Aug/87	318.2	317.1	304.5	0.4[d]	4.5
Finished Goods	Aug/87	297.2	297.8	288.1	0.0[d]	3.2
FEDERAL SPENDING AND DEBT						
Federal Spending Index (67 = 100)	Jul/87	637.0	640.0	622.3	−0.5	2.4
Fed. Gov't Gross Debt Outstanding ($B) [a]	Jun/87	2,313.1	2,291.3	2,036.6	1.0	12.1
INTERNATIONAL TRADE						
Exports of Goods & Services ($B)	II/87	411.0	397.3	371.3	4.0	6.4
Imports of Goods & Services ($B)	II/87	529.7	509.5	472.1	2.6	8.1
Balance on Goods & Services ($B)	II/87	118.6	112.2	100.8	−2.1	15.2
WHAT'S AHEAD?						
Index of Leading Indicators (67 = 100) [a]	Jul/87	191.8	190.8	179.9	0.5	6.6

NOTE: All data seasonally adjusted unless otherwise noted

[a] Not seasonally adjusted
[b] Percentage point difference
[c] Less than 0.05 percent
[d] Index number not seasonally adjusted, percent change seasonally adjusted